THIS BOOK IS DEDICATED TO

My Dadaji (Grandfather) - Late Ram Lal Maheshwari (1927 to 1989):

Who helped me become a more intelligent person than what I would have been without his careful guidance. An engineer by education, my Dadaji helped me create a logical framework of understanding events in a classic cause and effect relationship. He would take pains to patiently answer all my questions, irrespective of how foolish they sounded to the other members of the family which helped me build the much needed curiosity in my thinking process.

My Nanaji (Maternal Grandfather) - Late Badri Das Damani (1927 to 2001):

Who as a stock broker was the first to introduce me to the world of investing. As a child, I still remember seeing the Economic Times at his place as I struggled to make sense of the content. He was more of a risk averse investor whose primary focus was to protect capital. More importantly, my Nanaji taught me that money isn't everything in this world and that after a person has achieved his goals he should think of looking at the world around with a selfless interest - a learning that I try to follow as much as possible.

My Papa (Father) - Late Suresh Maheshwari (1949 to 1999):

Who helped me think big - always. As a businessman, my father always engaged himself in a business that was really too big for his resources and rebuked me for thinking small which I did at that time. Though thinking too big isn't a prudent investing strategy, the ability to dream constitutes an integral part of every successful person's thought process. Maybe, that is why I was always focussed on making crores from the market even when I had just hundreds in my pocket. My ability to take big conscious risks through large bets is probably an inspiration from him as I continue to look for bets that have an ability to change my balance sheet rather than just focus on the payoffs that can merely generate income.

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Author's Note

DARE TO DREAM WITH STOCKS

Most investors can't figure out ki paisa jaldi banana hai ki jyaada?*

April 11th, 2001, I was sitting in the computer lab of a software training institute learning the art of using artificial intelligence to solve human problems, even though my mind remained nervously fixated in anticipation to the results that Infosys would report. The results came in quite early with a lower profit guidance of 30%, down from the 100% growth that the company was generating which sent the stock crashing down 17% and with that the entire market nosedived further into an abyss. As prices fell unabated, I was getting mentally prepared to the risk of my financiers rushing in to sell my over-leveraged accounts due to my inability to arrange further cash to meet up to the margin requirements.

The past couple of years had been disastrous for us. After my father passed away in October 1999, the Government of Jammu and Kashmir cancelled our mining lease, forcing us to leave our full fledged gypsum mining project without compensation. The project had sucked in all our savings and a little more, borrowed from friends and relatives and there seemed no recourse left. The battle was now to be fought in the courts and though we obtained a stay against the government's decision, the fight had to be given up as we ran out of money to pay the lawyers. As we relocated back to our family property in Kolkata, I was left without work and income. At that time, a friend suggested that anyone who could write software codes and move out to the U.S stands to make around $50,000 to $60,000 a year and hence I joined a software training institute so that the next phase of my life could be better than the earlier one. But no sooner had I joined this software training institute, the technology bubble was pierced and the entire market seemed headed for a brutal slowdown.

With nothing to do and the fees for software training course deposited I was half heartedly learning the skills which were the flavour of those times. However, I remained active in stocks with a portfolio that consisted of names like DSQ Software, Silverline, Pentamedia, Global Tele Systems and Sri Adhikari Brothers - all under leverage. These names reflected more of my ignorance and psychological build up rather than my intelligence and stock picking skills.

These stocks were far below their all time highs even as the story had folded for good. Despite this, I continued to hold them with the solitary hope of selling them out on a

** Most investors can't figure out whether to focus on the speed of the return or the size of the gain.*

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bounce. When a defeated investor waits for a higher price to sell his losers all that he gets in return is a new wave of selling that takes his shares to an even lower level. The same was happening to me as I continued to save my stocks from being sold by trying to answer margin calls by stretching to the maximum, till it reached a point on that April afternoon, where I could take it no more. As my financiers started to liquidate my portfolio to recover their dues, the damage was complete as it brought a long awaited closure to my first romance with the stock market.

In spite of this, I always thought that the stock market remained the only way to make a lot of money from a few. With nothing to do, I started to look for an activity that could be initiated with minimum capital and at the same time help me retain my independence. Even though I was academically qualified, taking a job was out of question as it would not let me follow my passion so the only option left was to become a teacher by starting a tutorial centre. There was a serious reluctance to take teaching as a profession because a few months back I was running a multi-crore gypsum mining project and the descent looked a little too insulting for comfort. But as beggars can't be choosers, I took to my new found profession with open arms and converted a section of my house to a learning center so that I could earn some money to make ends meet and also put it into stocks. I dared to dream with stocks to become rich - again!

While I used to take private tuitions during the morning and the evening, I spent time reading about investors who had made it big from the market. Though I had been investing for long, looking at stocks did not seem the same after that. Over the next few years, I followed it up with at least two hundred books on investing and each book increased my level of understanding both about stocks and the businesses that they represented. Price no longer looked the same as value and I learnt that good stocks could stay down even while the bad ones could move up uninterruptedly for a while - both without reason. My early years were wasted in searching for the low P/E stocks that were hitting their 52 week lows which was a classic way to lose capital. I experienced that there was more to stock picking than just the P/E ratio and the dividend yield. I also learnt that investing is not just a formula driven exercise but also a feel based endeavour. One has to feel about the product, business and the management in equal importance to sales, profits and valuations.

I also learnt the most important aspect of investing is that markets pay for growth and a company that is showing above average growth is like the child who always comes first in class - he always gets what he wants.

THE BIG BREAK:

I was desperate to get some capital to buy stocks as I was investing with just a few thousands each month. It was clear that the quantum of investment would have to be raised if I were to make a decent return from this game. One option was to sell my life insurance policies which in any case were under default due to my inability to pay the premium on time. Surrendering a life insurance policy to raise cash for investing in stocks

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was as blasphemous as it could get. However, I either wanted to have too much or nothing so jumped in to surrender my insurance policies and replaced it with a term plan instead.

Meanwhile, I persuaded my mamaji (maternal uncle) to lend me some shares so that I could borrow against the same to invest in the markets. The timing of these events could not have been more perfect. As I raised cash against the borrowed shares, the cheques from my surrendered policies also dropped in and they coincided with the 9/11 crash of the twin towers. This gave me a chance to double and triple my money in the beaten down software names like HCL Technologies and SSI in a few months. These profits were then diverted into Eserve, Mphasis BFL and Mastek as IT enabled services and BPO seemed to be the new theme at that time.

I continued to buy and invest in shares instead of diverting the quick income to the safety of fixed deposits and bonds. My plan was clear, I was willing to have very little money against an outside chance of making lots of it.

I took investing a little more seriously after 2001 because I knew that I did not have a second chance. The option of losing money on capital created out of leverage was simply unacceptable. Maybe that is why I have always been paranoid of the risk and try assessing the probability of permanent destruction of capital from any investment before evaluating the upside triggers of the same.

OPENING UP MULTIPLE SOURCES OF INCOME:

Investing out of savings was one way to increase my stock market exposure; the other was to look at new sources of generating income. To augment my income stream, I started conducting classes on stock market investing, took up mutual fund distribution and engaged myself in many other activities so that I could put more money to work.

While increasing income was one way to put more money in stocks, taking leverage on the existing holdings was another. I followed these two things by postponing expenses and for which I was more than adequately supported by my family members. For instance, I did not own a car till 2010 when I bought a used Honda City. The idea of buying a depreciating asset did not make sense to me especially when my investments seemed to be going up ten, twenty and forty times, I do not remember taking a holiday till 2010 just because there was an opportunity cost attached to each rupee of spending.

I could have of course taken a holiday and bought a car in 2003 itself.

Overall, my little story was backed by a firm belief in stocks and by the advent of new investing opportunities that came my way during that time. Given a chance again, I seriously doubt if I would be able to replicate again what I could in the last 13 years. This book is all about my journey in the stock market and my decision to dare to dream with stocks.

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MY EARLY YEARS:

I was born in an educated middle class family but was just about mediocre at studies. Being a not so bright student and not a dumb one either meant that I had to go with commerce in high school. Surprisingly, I became a better student the moment I took up commerce and in about a few months I was topping the class and was the school topper in the high school exams which got me an admission in Shri Ram College of Commerce (SRCC). Though I went to SRCC, I returned back in a week as I could not handle the ragging at all!

I finally graduated from St Xavier's College, Kolkata and almost simultaneously got a Cost Accounting degree as that was the only course that could be pursued with graduation at that time. I have always felt that education does not matter too much as to how an investor performs in the market. Making money from stocks requires as much skill as it needs an emotional balance and while there are many people who can display their skill at picking stocks there aren't too many who can be confident at having the right kind of emotional balance when it comes to playing the investment game.

Earlier, I used to think that having a finance background is essential to succeed in the market but now I am convinced that having a degree in finance is essential if one has to work as a research analyst but not so much important if he wants to be a successful investor. Personally, I rarely get into the depth of research as many think I do because the big picture call is more important to me than the critical line by line analysis.

As a one man research team, I focus very little on financial modelling. I have no subscription to any real time newswires nor have any standard financial software for running screeners or any query at my command. All my information is sourced freely from the internet. Even though I read brokerage and analyst reports, the underlying interest remains to look for the general opinion on the street rather than to form my opinion on a stock.

WHY DID I WRITE THIS BOOK?

There are hundreds of books on investing and the idea to write one more was crystallized because I thought that my effort would provide a different perspective from what actually exists in the marketplace. This book 'The Thoughtful Investor' is thus an attempt to combine the various facets of investing and bring them under one roof so as to present an investor with a strategy that should generate consistent long term returns irrespective of where the overall market is going.

Having been actively involved with stocks for over two decades now, I have understood that the stock market is a game of snakes and ladders where it is as important to look for the ladders as it is to avoid the snakes. Taking this theme forward, this book is a reflection of my strategy in guiding an investor to make enough from stocks, so that he becomes - financially free.

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I have seen that the general investor still thinks about stocks as a money making exercise rather than a wealth creating endeavour. How many investors come to the market with the firm belief of making over ₹5 crores from a start up capital of ₹10 lacs is a question whose answer I keep looking for, all the time. Making an investment grow fifty times in twenty years can be achieved by generating a compounded annual growth rate of 22% only and while critics will argue with the inflation adjusted value of ₹5 crores, twenty years from now the better thing to do is get to that figure first and worry about inflation later on.

In reality, most members of the investing community lack that perspective.

Taking early profits from good companies and sitting with losses on the bad ones just because the purchase price is above the current market price forms the critical attribute of the uninformed investor. A naive investor also looks for low priced inferior businesses with little emphasis on the management factor. These investors remain fixated with valuations and are more than likely to miss any multibagger opportunity either by ignoring the stock because of its high valuation or by selling out too early in the fear of losing back all the accumulated profits.

I have tried to address these common investor attributes so that the small investor achieves the necessary skills to become a large one.

None of the books written so far have comprehensively tried to cover the Indian markets. My attempt at sharing my ideas and experiences are backed with real examples of stocks from the Indian market with regard to both the companies that made it big and those that could not. I have personally tried to share my experiences as far as possible to support the practical angle to the whole debate. These chapters have also been put up with relevant info-graphics to increase the retaining power of the reader.

My children also remained the biggest source of inspiration when it came to writing 'The Thoughtful Investor'. A father always wants to share his knowledge and ideas with his children. As my children are small, I sometimes wondered on the mode of this knowledge transfer if a car that I was travelling in, rolled over the edge of a mountain cliff. This book would therefore come in handy if my kids were to decide in becoming full time investors when they grow up.

This book took me over twelve months to write and is an arrangement of my experiences gathered over the last twenty two years of my investment career. Even though I have been in the market since 1992, I wasted the first nine years and interestingly what I did in the next thirteen was diametrically opposite to what I used to do in the first nine. I learnt later that an investor can never expect to succeed with just one strategy. Markets change all the time and the participants have to keep evolving to the new dynamics if they are to become accomplished players of the field.

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I have tried to share all that I know about stocks in this book. The book pretty much defines my investing strategy both in style and scope that has helped me survive and profit from this game for the past several years and I remain convinced that the same would help the reader in his journey to achieve financial freedom - through stock market investing.

After reading the book, you can log in to the forum of the website www.theequitydesk.com for a discussion on the contents of the book along with other fellow readers, where I would also try and participate so that the interactive feature of the web is retained with the old world of paper. We can open separate topics for each of the sections or chapters so that the process of learning and sharing can be expanded on a larger scale.

I also look forward for your reviews at www.thethoughtfulinvestor.in .

With best wishes,



Basant Maheshwari

March 06, 2014

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BASANT MAHESHWARI'S INVESTMENTS EXCEEDING 90% IN VALUE OVER THE PERIOD (2001-2014)

Period of Holding	Company	Returns
2001 - 04	E- Serve	6 times
2002 - 03	Mphasis BFL	2 times
2002 - 04	Bharti Alrtel	5 times
2002 - 04	Hinduja TMT	3 times
2003 - 06	Trent Ltd	6 times
2003 - 07	TV18	14 times
2003 - 08	Pantaloon Retail	40 times
2007 - 08	Axis Bank	60%
2008	Voltas	(- 60%)
2008 - 13	Titan Industries	6 times
2009	Blue Star,Thermax, Voltamp	2 - 3 times
2008 - 15	Page Industries	40 times
2008 - 15	Hawkins Cookers	10 times
2010 - 11	Zydus Wellness	2.5 times
2011 - 15	Gruh Finance	5 times
2013 - 15	Repco Home Finance	4 times

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CONTENTS

A) The World of Investing:

01. The Business of Investing 1 - 8
02. Magic of Compounding 9 - 19
03. Equities Don't Outperform all Asset Classes all the Time 21 - 28
04. Attributes of a Full Time Investor 29 - 33
05. The Pain of Losing 35 - 39
06. Risk vs. Return 41 - 45
07. Buy What You See 47 - 55
08. Macro Numbers – How Much to Analyse? 57 - 63
09. Intrinsic Value – Theory and Practice 65 - 69

B) Bull market, Trends and Economic Bubbles:

10. What Makes for an Economic Bubble? 71 - 74
11. Brief History of Economic Bubbles 75 - 94
12. Identifying Tops and Bottoms 95 - 109
13. Identifying the Next Big Trend 111 - 122
14. Is Semi-Urban and Rural India the Next Big Trend? 123 - 127

C) Company and Financial Analysis:

15. Understanding Business Models 129 - 137
16. Tools of Financial Statement Analysis 139 - 152
17. Growth, RoE with DuPont Analysis 153 - 163
18. When Does an Acquisition Work and When it Doesn't? 165 - 174
19. Is Your Company Taking Up Market Share? 175 - 184
20. Evaluating the Management of a Business 185 - 194
21. Dividend - The Only Sure Thing from a Stock 195 - 203
22. Operating Leverage - Looking for Margin Expansion 205 - 210
23. How Companies Cook Books of Accounts 211 - 219

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24. Stocks to Avoid 221 - 231
25. Drivers of a P/E Ratio 233 - 242
26. P/E Expansion vs. P/E Contraction 243 - 255

D) Buying and Selling Strategies:

27. Should a Small Investor Always Stick to Small Cap Stocks? 257 - 265
28. Multibaggers from Small and Midcap stocks 267 - 288
29. When to Catch a Falling Knife and When not to? 289 - 300
30. The Ones I Saw and Missed 301 - 308
31. When to Sell and When not to? 309 - 328

E) Analysing Sectors and Industries:

32. Basic Economy Stocks, Diversified Businesses and Spinoffs 329 - 339
33. Analysing Companies with Cash on Balance Sheet 341 - 346
34. Analysing Banks and Non Banking Finance Companies (NBFCS) 347 - 362
35. Commodity Cyclicals are not Long Term Bets 363 - 369
36. Analysing Holding Companies 371 - 375
37. PSU Stocks 377 - 382
38. Analysing Secular Growth Stocks 383 - 392

F) Constructing a Portfolio:

39. Portfolio Construction Strategies 393 - 408
40. When And How to Leverage and When not to? 409 - 415

G) The Last Word:

41. The Final Checklist: Contacting Company Management, Dealers And Distributors 417 - 427

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Chapter 01

THE BUSINESS OF INVESTING

Most Indians confuse stocks and shares to be exact synonyms of shocks and stares!

A majority of Indians consider investing as an extension of gambling and have no distinction to make between investing, speculating and gambling. Those traditional minded Indians assume the stock market to exist only as a 'get rich quick' scheme and irrespective of the odds the very act of engaging in a game of uncertain outcomes is assumed to be the quickest road to bankruptcy. The traditional Indian household has thus valued land, gold and bank fixed deposits much ahead of stocks and shares, maybe because it takes less skill to buy a piece of land or make a bank fixed deposit and even lesser thought to buy gold than it does to buy a bunch of stocks. Personally, I have all my money in equities and have not bought any gold or real estate ever because I feel more comfortable making investments with an open ended dream of creating an outsized gain, an event that is more likely to happen by buying a share of a business than by putting money in any other asset class.

As a consequence to this traditional mindset the percentage of Indians who think that wealth can be made by investing in stocks through pure fundamental research remains abysmally poor. Corporate profits, free cash flows, dividends and growth rates mean nothing to the traditional Indian household most of whom consider these numbers manipulated and meaningless. The strange belief in the orthodox thinking process is that there are only two things that can make money in the market. First is an access to a large Mumbai based operator or someone in the company who can tip off an information before the event actually happens and secondly, a premise that one has to be absolutely lucky to make money as the reverberating thought is that the game of uncertainty can be captured only by a stroke of

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chance. In reality, both these aspects provide the greatest danger to an investor's wealth as there are no free lunches available both in life and in the markets. *Most insiders, for reasons yet unknown to the investing community, prefer to recommend rather than invest and the insiders who invest do not recommend.* The tip offs from the father-in-law's step brother working as a dealer in the trading desk of the largest operator in the country is a sure shot way to portfolio destruction, as no operator recommends a stock before buying nor does he make a public announcement before selling. This makes the entire process of sharing information for charity completely misconceived and faulty. *However, the idea of being provided with ready made buying tips is always preferred to the process of undertaking serious research on the stock that an investor wants to buy because hearing is always perceived easier to thinking. It isn't at all ironic that the word 'tip' spelt backwards is 'pit' a place where most investors land when the 'tip' backfires!*

GAINS FROM INVESTING ARE NONLINEAR:

Many first time participants consider the stock market as an avenue of making regular income not realising that the market does not care if there is an immediate bill to be paid or a debt to be relinquished. The stock market is not a game which promises to pay an investor's monthly expense by generating periodic returns as the gains, if any, comes with a lag. *Since the gains are non-linear and come in bunches while expenses are linear and have to be paid off periodically there remains a permanent mismatch in paying off the expenses from stock market gains. Once the size of the portfolio increases, an investor can choose to pay off his expenses by his dividend income which in spite of being received once or twice a year is broadly definite in character, much like the investor's expense and quite unlike the capital gains that arises from the buying and selling of shares.*

NO BETTER BUSINESS:

The big advantage of investing in listed equites is the absence of a minimum threshold limit. An investor with a capital of ₹10,000 can participate in the fortunes of a textile business as easily as he can buy a share of a steel company without there being any obstruction on the smallness of the amount. The

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actual process and cost for an investor if he were to completely set up such businesses on his own would be significantly prohibitive. There is something called critical mass which entrepreneurs are supposed to bring to the table but an investor suffers from no such requirement. *An investor who buys stocks this way looks at being a part owner of a business whose fortunes are tied to the earnings potential of the company that he owns. A long term owner of shares should consider these entitlement certificates (shares) either in paper or electronic form as ownership rights to a business and a means of participating in the company's fortunes with limited capital even though in the short period the value of these shares could rise and fall without any reason.* But if the company does well it would over a period of time, reward its owners both through dividend and capital appreciation. All that an investor has to do is to back his decision with homework rather than hearsay.

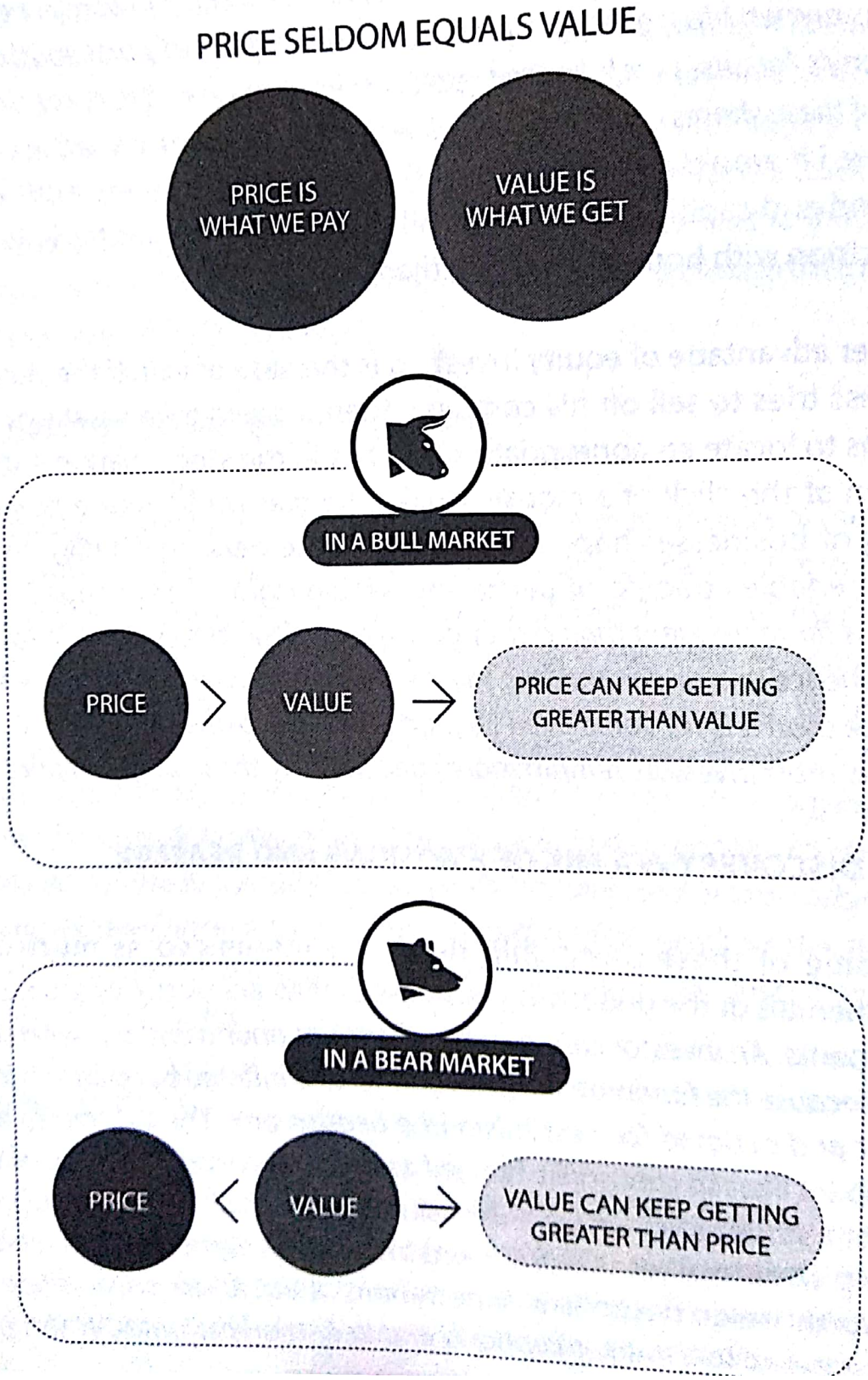
Another advantage of equity investing is the ease of exit. If the owner of a business tries to sell off his company then it could take weeks or maybe months to locate an appropriate suitor but in the stock market such deals happen at the click of a mouse. Unlike the real world where buying and selling of businesses happen through private deals in totality, the stock market enables trading of partial ownership rights. *The change in price of shares is more frequent than a change in value of the business and it takes a lot of experience and understanding to note that the frequency of change is higher for price than it is for value even though instead of being worried by a change in value, most investors remain more concerned by the changes in price.*

PRICE DISCOVERY IS A MIX OF EMOTIONS AND REASON:

The value of these ownership rights are influenced as much by the fundamentals of the underlying business as they are by the emotions of the participants. *An investor can sell when there is euphoria and buy when there is panic because the fundamental price of a stock is inflated by optimism in a bull market and deflated for pessimism in a bearish one.* Though every market participant likes to categorise himself as a value investor the price which he pays for a stock either exceeds the value during a bull market or falls below it during a bear market as bull markets are built on enthusiasm whereas bear markets thrive on pessimism. *Expectations about future prices is one of the chief causes of bull market euphoria and bear market panics.* When people

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expect higher prices they don't mind buying something for more than what its worth today as long as they are confident of selling it at an even higher price tomorrow. The cycle repeats itself and is often touted as a 'Greater fool theory' where each fool looks for a bigger fool and when there are no more fools to be made the last fool in the chain is made up to pay, an event that brings the entire bull market to a stop.



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A similar case repeats itself during a bear market where an investor worried about lower prices looks to sell something for less than what it is worth today. Here the fundamental price of a share is reduced by the fear factor as prices keep falling lower than what they should actually be.

However in practice, it is very difficult to understand whether price is ahead of value or below it. The only takeaway an investor can draw from this theory is that if price is divergent from value and most of the time it is, then there exists an opportunity to make money either by selling a stock or buying it.

Unlike the secondary market where shares are traded five days a week, private deals on the other hand, happen more or less in the fair value range because they do not get inflated by leveraged buying nor get depressed by margin selling. It is easier to get a better deal buying listed securities (bear market) than in buying real businesses the direct way. Conversely, it is also easier to get a bad deal in listed securities (bull market) when compared to real businesses. But being a good investor is different from being a good business man because a businessman can lose 100% in one go but the risks of investing can be controlled by diversifying across stocks and sectors.

LONG TERM WEALTH CANNOT BE GENERATED BY SHORT TERM TRADING:

People who buy shares for a few hours as part of the day trading plan are more dependent on the mood and emotional swings of their fellow investors than on the fortunes of the company. *Investors who identify one big investment idea every twelve months make more than people who find a new stock to bet every twelve hours.* The short term trader would buy and sell shares of a Punj Lloyd with as much gusto and ease as they would for a Punjab National Bank. People who participate in fierce short term trading are actually playing a game of chance as most short term traders engage in buying and selling shares because they get hooked to the charm and excitement of fluctuating prices than with the objective of making big money. This hobby slowly becomes a habit and then an addiction, before making the participant a compulsive gambler. Unlike a profession, habits and hobbies cost money whether it is playing golf, rock climbing, bird watching, photography, smoking or even drinking, all addictions come with a price tag which the non-serious

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investor keeps paying to the market day in and day out. The compulsive gambler though, enjoys paying up the money as he derives a sense of satisfaction out of it. He enjoys by losing so continues to lose - just to enjoy.

The science of zigs and zags is an opportune way to go from riches to rags. Most short term traders base their buying and selling strategies on technical analysis which generates buy and sell signals on the basis of moving averages, breakouts, breakdowns, overbought, oversold, head and shoulders etc. While these tools are essential for the people who are focused on short term trading too much of reliance on these kind of strategies will not allow an investor to make big money from the market. *The focus of investing should be to buy stocks that carry a potential to move up 10 times and not on the ones that promise a random 10% upmove.*

A CONTINUOUS LEARNING PROCESS:

All stock market participants engage in what is called a continuous learning process. Contrary to popular belief there are no experts in this game and each transaction fulfils two motives either it teaches the investor a new lesson or increases his conviction to an old one. Unlike a formal education program where a candidate gets to make money only at the end of the learning session a stock market participant gets to make money while at the job even as he continues to learn till the very end.

TOWARDS FINANCIAL FREEDOM:

Early retirement is the biggest lure for hard work and anyone who works, wants to reach that stage in life where he does not have to work for money while his money works for him. But achieving these goals takes a lot more than making a few profitable investments as an investor will have to work from all sides. *He would need to increase income, reduce expenses while simultaneously keep making profitable investments. Once his investments start expanding in value he will have to restrain himself from taking early profits.* Letting the profits run unless there is something wrong with the company is the only way to make enough from equity investing. It is fair to assume that the initial amount that an investor brings to the table will be small but if he manages to put this on the right stock which shows the right kind of

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price movement then as an investor he would be compelled by reason and advice from others to take money off the table not realising that no one makes a fortune by selling a stock that has just doubled in price. *An investor has to be lazy in taking profits and agile in cutting losses.* Good companies are supposed to occasionally get ahead of their current fundamentals and if the stock that an investor has bought moves up with the company's prospects, it makes sense to hold on or even buy more especially if the underlying business is indicating excellent prospects ahead.

Buying more of a stock after it has moved up from an investor's initial purchase price is a lot tougher than selling it to lock in the gains. But the tough decision is more often the right decision. As a part of an investment strategy an investor seeking financial freedom through the equity route should focus on smaller capitalised companies that are leaders in their sectors and growing revenues at a fast clip, preferably with a growing dividend yield. A small cap stock works on a small base with potential for supernormal growth whereas the life jacket of dividend yield protects the investor from the downside movement in the stock.

However, once the stock has been bought there will be several instances when an investor will be faced with the dilemma of cashing out for safer investments or for using the proceeds to buy the smaller luxuries in life, like putting up a downpayment of a car, a flat screen TV, buying jewellery for his wife, a nice holiday or even a new sofa set. Funding these expenses through an investment that has gone right boomerangs back, as it converts an appreciating asset into a depreciating one which negatively impacts the process of wealth creation.

The process of getting rich for a big everlasting smile entails sacrificing a lot of these small happy moments. The option for the investor should be clear as to whether he wants to be happy in these small moments or create a life time of happy moments. To do the latter, he would have to struggle, wait, dream and at times feel bad when the stocks that he has bought fall in value while his neighbour takes off for that long summer vacation to the Alps.

The risks that an investor will take in this process will also accentuate as he should allocate the maximum amount to equities and refrain from diversifying.

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Term insurance policies for the life of the earning member is a must as the concept of buying pure insurance cover should be revisited while doing away with the artificial frills of money-back and endowment linked insurance plans.

To attain financial freedom an investor must strive to have at least a corpus of fifty times his annual expense. Fifty times annual expense means an investment corpus of ₹2.5 crore for a family that intends to spend ₹500,000 on household expenses each year. The logic behind this fifty time number is that at a yield of 2%, which all decent portfolios should generate over time, the dividend income of his portfolio should take care of his daily expense. If in some years, the yield falls short of the 2% mark then he can sell some shares to make good the deficit and hope to catch on in the later years as the yield of a group of carefully chosen businesses should grow at a rate significantly ahead of inflation.

The path to financial freedom is not an investor's personal journey. He has to get his immediate family which includes his spouse and other active members into the process. The process of an investor postponing immediate comforts for the benefit of future luxuries is a family decision and not an individual one. It cannot be achieved by the pains and sacrifices of a single member so there has to be a conscious family decision to either participate in the immediate sacrifices for the future good or else engage life as and when it comes. It is generally difficult to get the family consent as not all members are willing to participate and sacrifice the present comforts for an uncertain and unknown future dream. *The fight remains between a bird in hand and several in the bush.*

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Chapter 02

MAGIC OF COMPOUNDING

A small investor should first let his investments grow before he starts thinking of it as a money plant!

If a person had invested one rupee at the time Babur invaded India in the year 1526 A.D then on a nominal 3% rate of interest it would have grown to ₹17.85 lacs; at 4% to ₹19.73 crores; at 5% to ₹2,085 crores and at 6% to ₹210,841 crores. The ability of a rupee of investment to grow to astronomical sums of money over a period of time even at moderate rates of return is known as the magic of compounding.

Archimedes, the Greek scientist had argued about lifting the earth through application of a moderate human force on a lever whose one arm was several hundred thousand times longer than the other one. While the actual theory could be debatable, the spirit of the argument can be extended to the magic of compounding which states that even small amounts of initial capital, compounding at moderate rates of return, can over longer periods of time, create a mountain of wealth.

The origin of the magic of compounding is the following compound interest formula that we were taught in primary school:

$$P(1 + R/100)^N$$

where:

P = Principal

R = Rate of return

N = Number of years

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We now reframe the equation:

$$I(1 + CAGR/100)^T$$

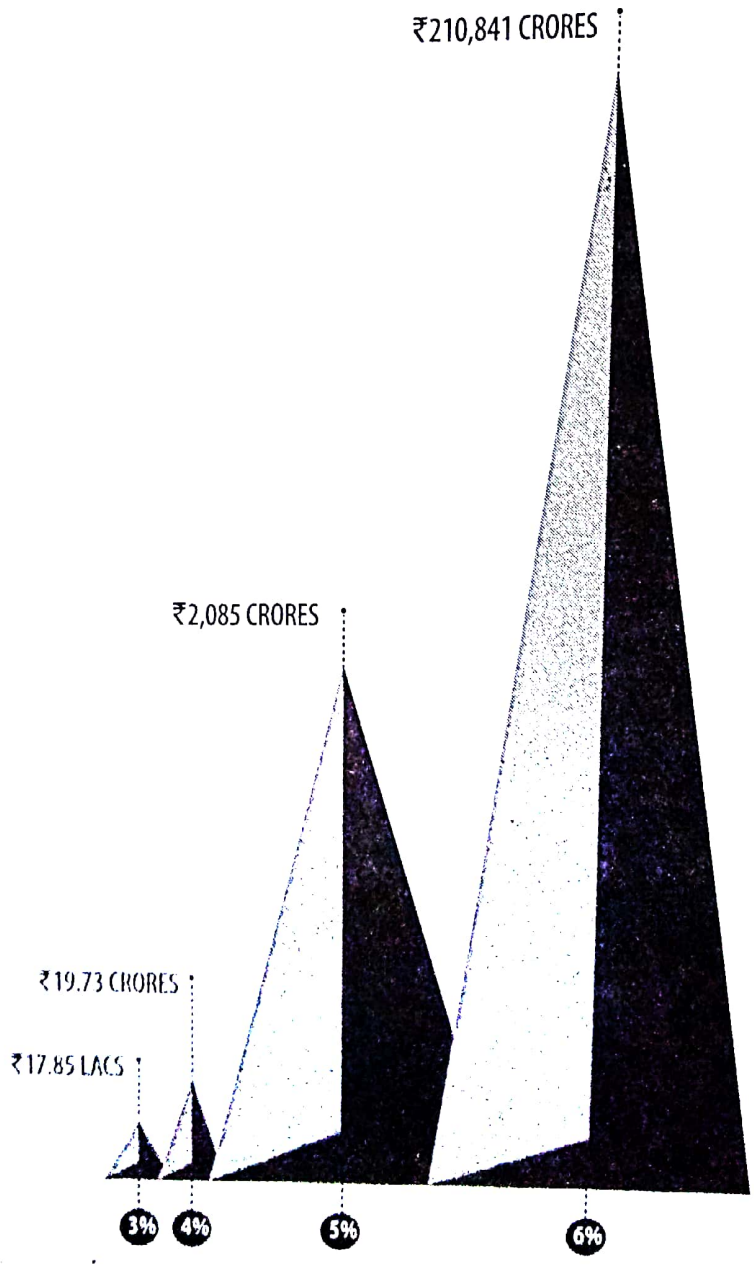
where:

I = Initial Amount

CAGR = Compounded Annual Growth Rate

T = Time (number of years)

HOW MUCH WOULD A RUPEE HAVE BECOME AT DIFFERENT RATES OF RETURN FROM THE TIME BABUR CONQUERED INDIA IN THE YEAR 1526 A.D?



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INITIAL AMOUNT:

Unless an investor can bet* enough, he does not get rewarded for being right as he normally ought to be. There are not too many instances in an investor's life where he would be right with his investments so when he is the attempt should be to try and make the maximum out of it. *Personally, more than 90% of my wealth has been generated from less than ten stock ideas only. Making meaningless and insignificant token investments that do not have the power to change the balance sheet of the person is only an ego massage and does nothing to advance his process of wealth creation.* A great idea does not come often and when it does the need of the hour is to bet big and hold it for the entire duration of the upmove as it is more profitable to be allocating large amounts of capital on a moderately winning investment than it does to be betting with smaller amounts on a super sizzling risky venture as betting too much on a hot idea comes with the risks of capital destruction whereas with a moderately winning investment the investor can put larger amounts of money to work.

THE CAGR:

The entire investing community is fixated with the rate of return that an investment is supposed to generate over time. When this rate is equated in annualised form for periods exceeding more than a year it is expressed in the form of CAGR. Most investors keep focusing on the CAGR as they are devoid of time and want to get rich quickly because generating a high CAGR has the power to magnify a small investment 'I' in the shortest period of time 'T'.

The CAGR is the only distinguishing feature of an asset class and varies from one asset to another. While the 'initial capital' that an investor brings to the table and the 'number of years' that he intends to retain his investment are completely in the hands of the investor and remains the same for all assets, the rate of return

*In this book, I have used the word 'bet' quite interchangeably with 'investment' as all investments being uncertain payoffs are akin to a bet though in the normal state of thinking an investment is an informed bet rather than being, merely a roll of dice as the name suggests it to be.

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is a market determined number and is unique to an asset type whether stocks, bonds, metals or real estate.

TIME (NUMBER OF YEARS):

Generally, a new investor focuses only at the 'CAGR' or the rate of return that an investment is expected to generate. *He remains completely oblivious to the fact that it is possible to reach a predetermined number even at a lower rate of return just by staying invested a little longer or by starting early.* There is just no substitute to starting early in the investment game even if that means postponing the luxuries of life for a later date.

Most people do not initiate their investment process till its too late and thereby waste the first few crucial years which gives them less time to compound their investments.

An investment compounding at 20% each year for seven years, will take nine years and forty eight days to generate the same kind of money if the asset compounded at 15% instead of the originally conceived 20%. However, as investors want to compress the returns in the shortest possible period of time they fail to realise that to make a lot of money an investor need not compound at the highest rate of return but just stay invested a little while longer.

This number recognition of combining the return with the tenure of investment represents the first sign of a mature investor.

Achieving a CAGR of 20% for a few years is commendable work but doing it for six decades makes up a Warren Buffett. The 'T' therefore is the number of years that the amount is left to compound at and is as important as the 'CAGR' since the 'T' is also the numeric that the entire expression is raised to the power of.

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THE COMPOUNDING TABLE:

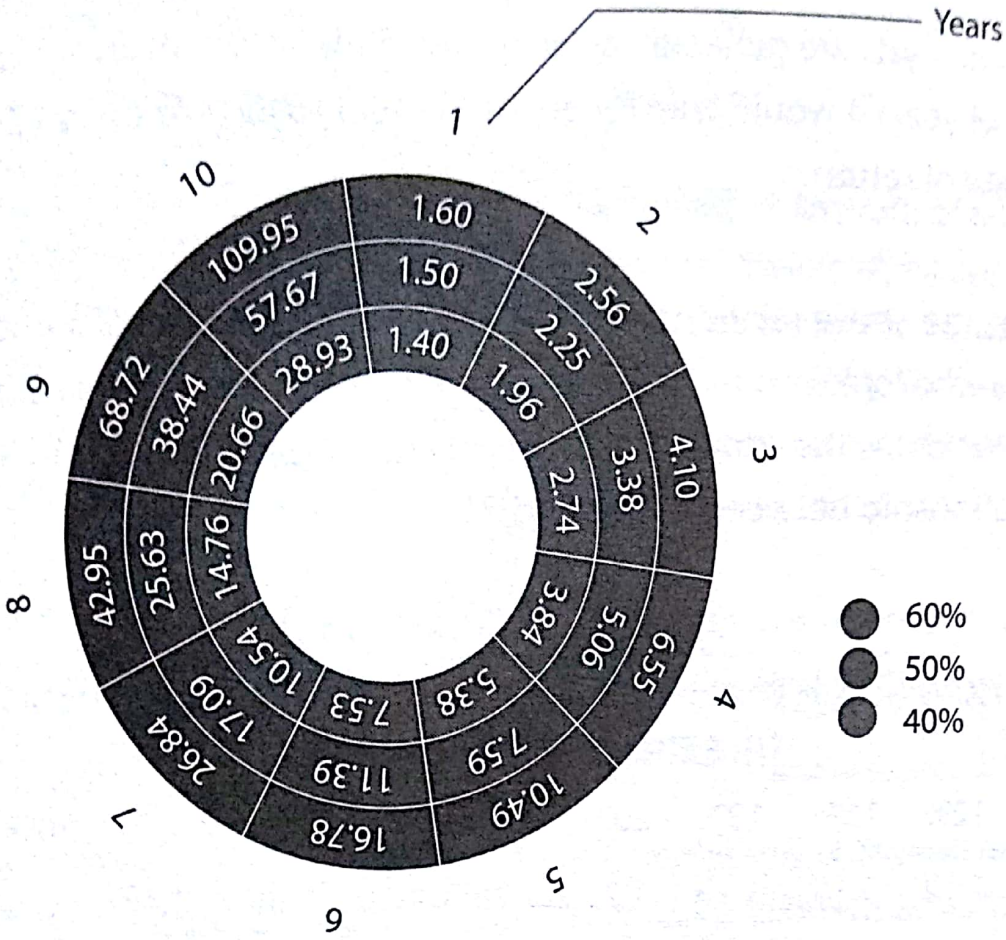
Financial analysts are generally aware of the 'Rule of 72' which indicates the number of years it would take for an investment to double up, is 72 divided by the rate of return.

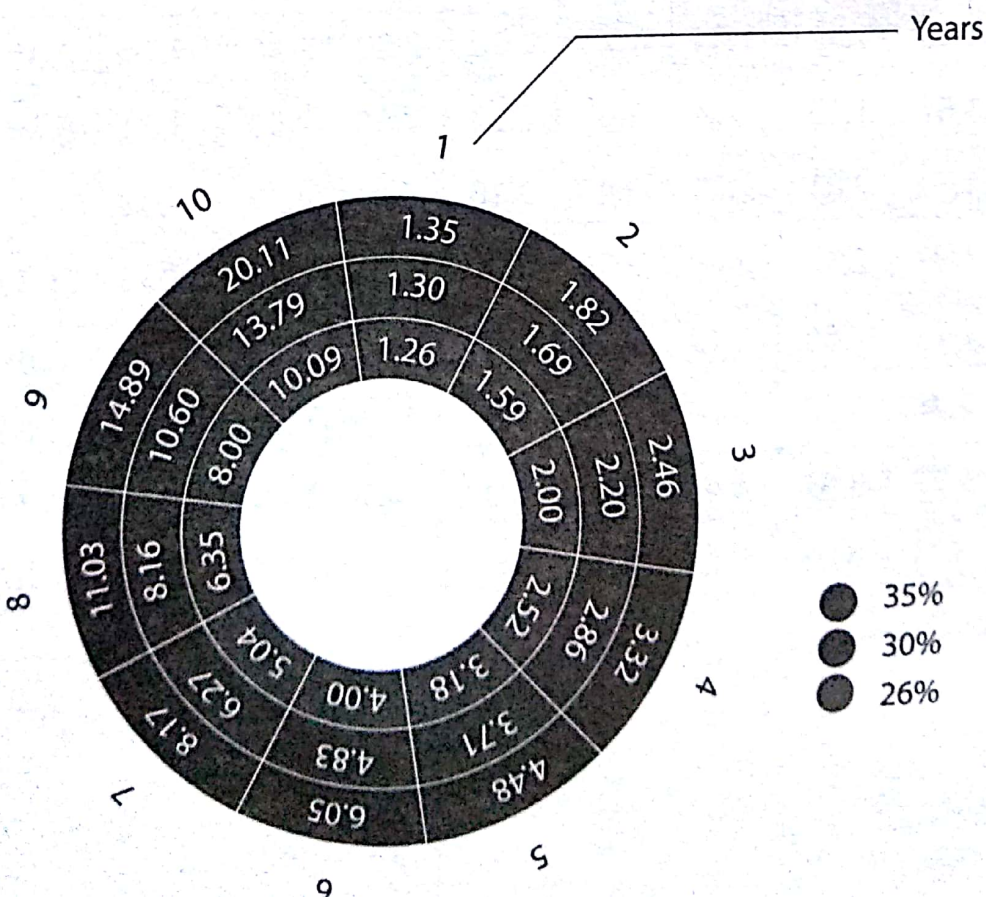
However, the above relationship is restrictive as it only talks of a double but investors who look for a more exhaustive relation can use the following table which elucidates the concept of magic of compounding by expressing the interrelationship between 'CAGR' and 'T'.

HOW MUCH DOES A RUPEE OF INVESTMENT BECOME AT DIFFERENT RATES OF RETURN?										
Years	12%	15%	18%	20%	26%	30%	35%	40%	50%	60%
1	1.12	1.15	1.18	1.20	1.26	1.30	1.35	1.40	1.50	1.60
2	1.25	1.32	1.39	1.44	1.59	1.69	1.82	1.96	2.25	2.56
3	1.40	1.52	1.64	1.73	2.00	2.20	2.46	2.74	3.38	4.10
4	1.57	1.75	1.94	2.07	2.52	2.86	3.32	3.84	5.06	6.55
5	1.76	2.01	2.29	2.49	3.18	3.71	4.48	5.38	7.59	10.49
6	1.97	2.31	2.70	2.99	4.00	4.83	6.05	7.53	11.39	16.78
7	2.21	2.66	3.19	3.58	5.04	6.27	8.17	10.54	17.09	26.84
8	2.48	3.06	3.76	4.30	6.35	8.16	11.03	14.76	25.63	42.95
9	2.77	3.52	4.44	5.16	8.00	10.60	14.89	20.66	38.44	68.72
10	3.11	4.05	5.23	6.19	10.09	13.79	20.11	28.93	57.67	109.95

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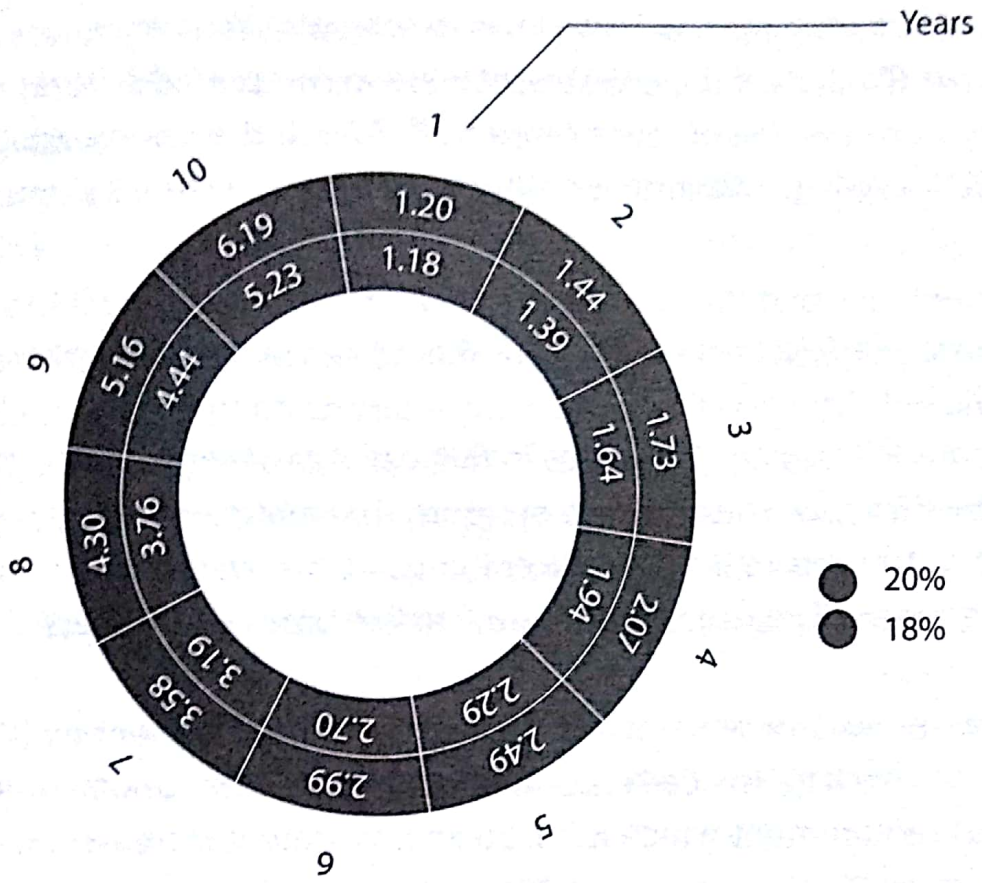
THE WHEEL OF WEALTH

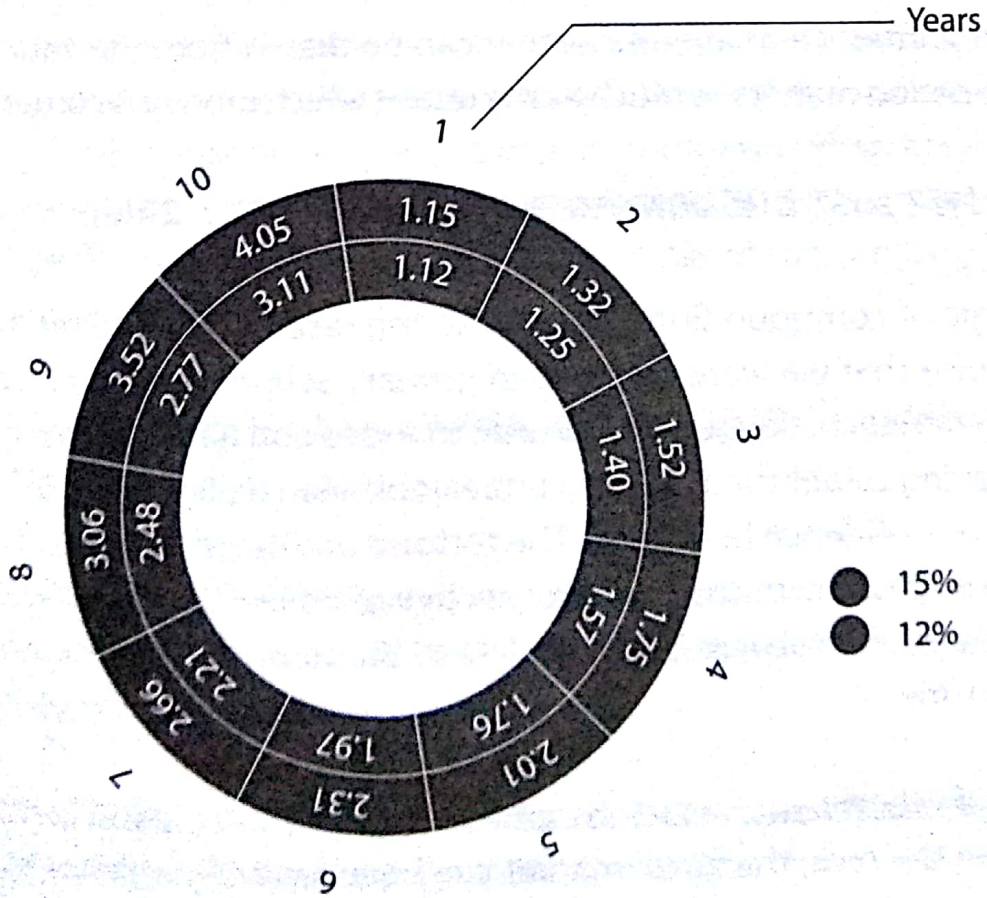




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THE WHEEL OF WEALTH





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As an investor moves down the table, the gap for different values of 'CAGR' and 'T' widens quite significantly for example, an investment that generates a 26% CAGR multiplies itself ten times in ten years thus making it a 10x10 investment. Similarly, if the investment were to compound at 30% each year it would grow a rupee of investment to ₹13.79 in the same period and at 60% CAGR an initial investment multiplies itself 109.95 times in ten years.

Another way of using this chart is to search for the 'CAGR' to get to a desired investment value on a specific 'T' (number of years). As years are marked in the rows and the rate of return in the columns an investor who looks to increase his investment five times in five years can search for the figure '5' under the fifth row. Thus the rate of return that matches his requirement is located within the 35% and 40% columns as between these two rate of returns a rupee of investment can grow to five times in five years.

Similarly, an investor who intends to increase his investment by five times at 18% can check for the corresponding row in the years column that meets up to this requirement which is 10. So an investment increases 5.23 times in 10 years.

One of the interesting inferences that can be drawn from this table is that the time period matters as much as the rate at which money is compounded.

THERE ISN'T JUST ONE WINNER IN THE INVESTMENT GAME:

The magic of compounding is much like the race between the rabbit and the tortoise that we were narrated in primary school. The story goes that once the rabbit challenged the tortoise to a race and halfway through it the rabbit having established quite an unbeatable lead decided to take rest and in his overconfidence fell asleep. The tortoise on the other hand continued to roll slowly without stopping irrespective of where the rabbit was. When the rabbit finally woke up it was too late as the tortoise had crawled over to the finish line.

Unlike the rabbit and the tortoise where only one of the participants could have won the race, the stock market can have multiple winners as well as

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multiple losers as It gives all participants a chance to win or lose - concurrently. The only ones who lose are the ones who leave the game well before the finish line as they find it difficult to survive the market for an extended period of time. This is also unlike a cricket match where if Australia scores 434 runs in their allotted 50 overs, South Africa have to get 435 to win, its not an event like the Oscar where only one movie can win the title or like soccer where there can be only one champion team, its not a binary zero or one.

In the market, different participants having different CAGRs can also win the game. If Warren Buffett's Berkshire Hathaway generated a CAGR of 19.7%; Michael Steinhardt 24.5%; John Neff 13.7% and Peter Lynch 29.2% all of them were declared winners but the biggest winner has been Warren Buffett because he could play the game for the longest period of time. Though Warren Buffett worked with a lower 'CAGR'; he really pulled it across because of his 'T' in spite of starting with a modest $10,000 'I'. The 'T' worked well for Buffett because he started investing at the age of eleven and now at eighty two is still in the game with as much passion, vigour and focus.

So whether an investor does a CAGR of 26% or 21% or even 15% what matters is how long he can be at the game without getting pushed out of it. Investors should realise that this game is not about winners take all but its about survivors making enough. If a person can remain involved with this market continuously for twenty years with passion, commitment and seriousness he would see at least three bull markets and would make enough to reach the stage of financial freedom. However, if he thinks of compressing the time he runs the risk of death by exhaustion.

COMPOUNDING WORKS ONLY WHEN AN INVESTOR CAN AVOID THE NEGATIVE YEARS:

Another interesting facet of using the magic of compounding to advantage is to keep the negative years at the minimum so as not to easily give away the returns of the good years.

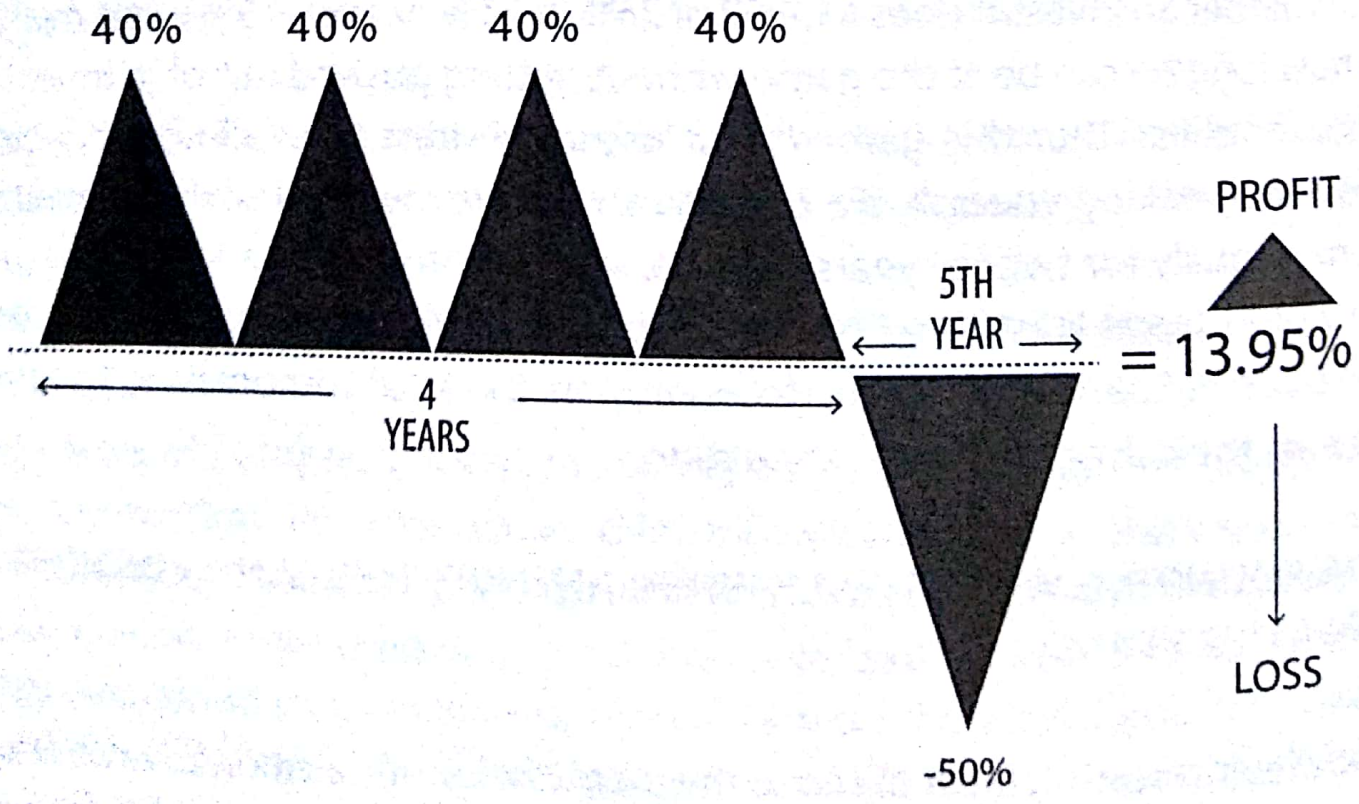
One of the notable features of the Buffett partnership in the early years of its existence was its ability to outperform the market in bad years where it

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kept losses in check. In the same way an investor should understand that one of the key drivers to maximising returns is to avoid the big mistakes. *Compounding works best only when there is no down year. An investor should evaluate each investment opportunity with the twin aspects of investing – risk and reward. If the risks are higher then no matter how big the rewards are he should sit back and introspect. Allocating small amounts will make negligible difference to the portfolio and by buying more he might put the good work of the previous years at risk.*

In this context consider an investor who makes 40% in a row for four years, a normal feat in a raging bull market and loses 50% in the fifth year an even more normal event post the end of the bull market. This loss of 50% in the fifth year brings down his overall rate of annualised return or CAGR to just 13.95%.

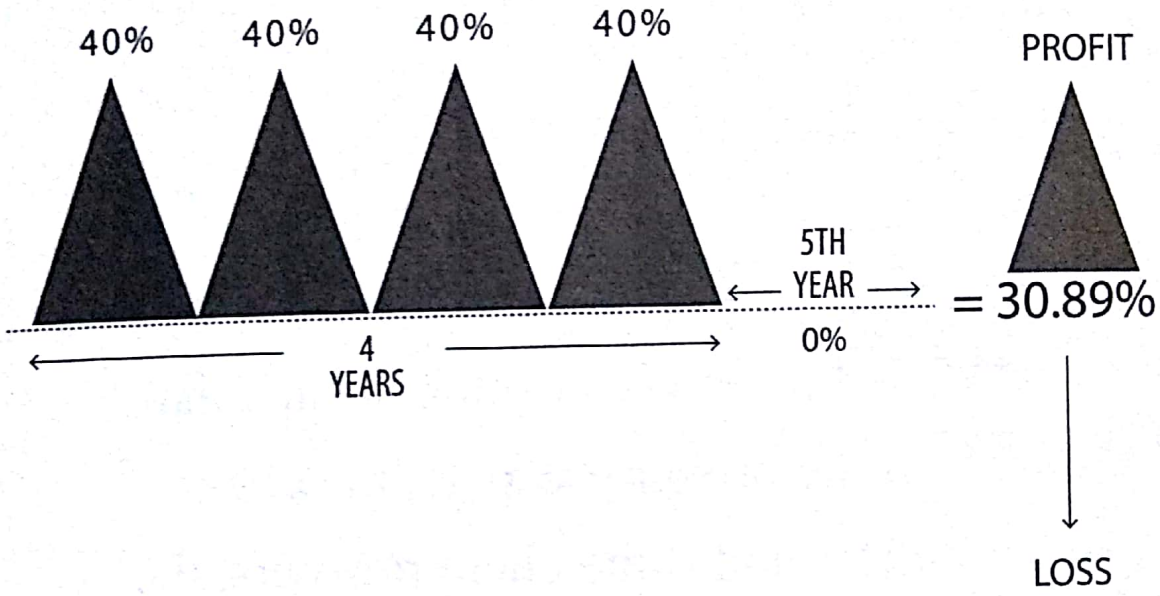
A NEGATIVE YEAR CAN WIPE OFF YEARS OF POSITIVE RETURN



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If in the above example an investor had just retained his wealth in year 5, with a zero percent return the average CAGR for the five years after having seen a 40% run for the first four years would have still been 30.89%.

MAKING MONEY ISN'T AS IMPORTANT AS RETAINING IT IS



All investors become careless and confident after four years of supernormal return and in order to keep the momentum running they move down the quality curve, buying low priced stocks of inferior businesses, with questionable management and debatable financials. In this endeavour, the investor takes maximum risk at a time when he should actually be controlling risk. Hence maximum damage occurs when the portfolio is nearer to its peak which washes away all the good deeds of the past.

In markets speed overrules size, most people look for the quickest money making stock and not the one which will make them the biggest gain. The best investment is therefore one which generates a higher rate of return, on a large initial amount over longer periods of time.

Merely generating a high rate of return isn't enough.

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"The broker-client setup is such that if the broker prospers, the client suffers and if the client prospers, the broker suffers!"

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Chapter 03

EQUITIES DON'T OUTPERFORM ALL ASSET CLASSES ALL THE TIME

Most investors don't understand that even though stocks outperform fixed deposits, unlike a fixed deposit stocks don't hit all time highs every second.

An argument that existing stock market participants provide to new and prospective investors is the ability of equity as an asset class to outperform all other assets over longer periods of time. The phrase "longer periods of time" is however left alone, completely undefined and is used just to enhance the attractiveness of investing in the stock market. *While equity markets do generate higher returns over other asset classes, these higher returns come in short bursts and without linearity when compared to income from fixed deposits or monthly salary credits.* A young first time investor who is out to make a quick buck soon realises to his dismay of course, that stock markets don't work on timelines and though the markets are generous in creating capital during a bull phase it is also brutal in taking all of it back and some more during bearish times. The irregular nature of stock market returns have therefore encouraged a lot of people to look at gold, real estate and fixed deposits as the other avenues of deploying capital.

WHY DO MOST PEOPLE PUT A HOUSE OVER INVESTMENT?

Most Indian investors have spent the last decade profiting from rising real estate prices as the abnormal rise in home prices have given a false sense of belief that no one loses money buying real estate. Real estate does well only if there is a boom in the overall level of economic activity but if the overall economy is in a slump, real estate follows suit. An investor who does not understand equities finds real estate as the best investment option but after

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he has bought his first house a down payment with regular EMIs cramps him with very little surplus for allocation to equities. The key differentiating factor in real estate investment is that two houses in the same locality don't have variance in returns as much as two stocks in the same sector can have. So the return from a GMR Infrastructure might be very different from the returns of a Larsen & Toubro quite unlike the near similar returns from two plots of land located at a small distance to each other. Furthermore, while buying a house a person leverages himself four times by putting up minimum money upfront which causes even small movements in real estate prices to get magnified, leading to large gains for the home owner. On the other hand, not too many people leverage while investing in stocks.

Real estate prices are not volatile as during a slowdown, prices hold their levels rather than fall down. This is because due to the low level of mortgage penetration sellers prefer to withdraw from the market rather than engage in distress selling which creates a vacuum. Real estate owners therefore do not have to go through the same trauma as stock market participants who are marked to market for every trade that one unknown person executes with another. It is this lack of volatility due to the illiquid nature of a real estate investment that encourages people to leverage a few times over their own capital.

Investment in real estate is made with a large amount of absolute upfront capital unlike investments in the stock market where an investor normally starts with a smaller outlay. *While an investor will allocate ₹5 lacs to stocks he would put ₹20 lacs as downpayment for his home so the initial amount at work is always larger for real estate.* With stocks the desire to take a partial profit will grow with every 15% rise in price whereas for his home he does not sell a part of it just to bring down the cost of the balance portion. Transaction charges, registration fees and other ancillary costs are always higher in a real estate deal when compared to the charges for a stock market transaction which subconsciously makes investors to hold onto their real estate assets for a bit longer than what they do for stocks. These things make the effect of compounding work in a better manner on a real estate investment when compared to that on stocks.

Finally, there is a peace of mind in not issuing rent cheques at the beginning of every month and having what people like to call as their own home but

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stocks lack that feel good. Moreover, the women folk at home can relate much better to a home than they can to a stock market investment which quite strongly swings the deal for home as a first investment.

Even though buying a house binds the investor into an asset class that compounds at a rate lower than that of a carefully chosen set of stocks it comes with a dose of mental peace as very few home buyers lose 70% buying a house on four times leverage while there might be a few who have lost that and more betting on stocks even without leverage. *The easy way to live a life is to let the first investment be a house and the simple way to make wealth is to put the first investment in a group of stocks and allow more time for compounding.*

NO TIMELINE IN STOCKS:

While there are no stipulated timelines to make gains from stock market investing the duration of bull and bear markets can extend to periods that are totally unexpected. History has shown that while bull markets last for shorter periods of time bear markets last for longer durations. In some cases, the bearish times may last up to twenty five years as it did in the U.S post the 1929 crash. In the Indian context, the Sensex went nowhere for eleven years post the Harshad Mehta bull run of 1992. *While returns from equity comes to an investor in bunches these returns are expressed in terms of compounded annual growth rate (CAGR), which is just an effective way of smoothening out the abruptness of these returns.*

While smaller portfolios are generally capable of generating a higher CAGR when compared to large sized portfolios, the challenge of making superior returns over longer periods of time gets magnified by the nature and character of companies available for investment. *Over the last twenty years 80% of all listed stocks in India have failed to beat inflation while during this period more than 50% of listed Indian companies have failed to deliver even a positive nominal return.*

The time period in which equities outperform all asset classes varies and fluctuates depending on a host of factors which includes the behaviour of

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indices preceding the computation period, the valuation of stocks at the start of the period and the stream of earnings* growth which is an outcome of the overall level of economic growth during the given time span. Consider a U.S investor who entered the market with the Dow at its September 3, 1929 peak of 381.7 points. Subsequently, the Dow suffered a 89.2% decline to 41.22 (intra-day low of 40.56) on July 8, 1932, thus erasing the previous thirty three years of gain. As the U.S GDP contracted by more than a quarter and the high valuations of the 1929 peak came in for a serious and severe reality check, it took twenty five years for the Dow to reclaim its 1929 peak of 381.7 (intraday high of 386.1) points. In fact, if someone had bought the Dow at the peak value in the year 1929 he is now getting 15,780 in November 2013, for it. The resultant CAGR for all this effort exclusive of dividends has been 4.53% only. On the other hand, if someone bought the Dow in 1932 from its lowest level of 41.22 points the CAGR would have been 7.62%. Clearly in an environment where most fund managers fail to beat the Dow or the underlying index, equities isn't such a block buster asset class that promises to change lives, create retirement funds and generate surpluses in a fashion most investors think it to be.

Many would argue about the brilliance of catching the 1929 bottom while the rest would debate about the folly of catching the top but we are just discussing thoughts here, which is necessary for us to understand the complexities of the business.

Similarly, the Dow went nowhere from 1967 to 1982 where for 15 years it fluctuated in a range. Thereafter, from a nominal value of 777 on August 12, 1982, it rose more than 15 times to reach 11,722.98 points by January 14, 2000. This fifteen times move in the Dow came without any major drawdowns except for the severe crash of October 19, 1987, when the Dow fell 22%; its single largest daily percentage loss in history.

*The term 'earning' or 'profit' growth has been used several times in this book and in all those cases what is being referred to is a growth in earning per share rather than growth in absolute profits. This is because if a company grows earnings by diluting equity the net increase in EPS remains smaller when compared to the increase in absolute levels of profitability. It is therefore important to focus on growth in earning per share rather than growth in absolute levels of profitability.

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One can envy the investor who bought the Dow in 1982 and stayed invested for the next eighteen years or pity the one who entered the market in 1967 and stayed invested for fifteen years before booking out in 1982. *Clearly returns in this market have never been linear but equity as a product is sold as one where an investor is expected to make money year on year. In reality, money is made in bunches for some years and lost in the others and the residual of gains over losses is converted to a CAGR format and sold to investors as dreams!*

FOCUSSED PORTFOLIO WORKS BEST:

In spite of the data presented above it is not unnatural for a few investors to keep outperforming all asset classes by buying a select group of stocks from sectors that are doing well during that period of time by having a focused portfolio approach. A focused portfolio approach is one where an investor chooses a few stocks from a handful of sectors and tries to beat the indices and other asset classes over longer periods of time. Merely buying the index isn't enough more so in India where the index itself is market cap weighted instead of being price weighted as it is in the U.S. A market cap weighted index remains skewed to a few stocks and also distorts returns for the investor. So while index investing worked in U.S, it might not be that profitable a strategy to follow here in India.

Even in the BSE Sensex, the top four stocks TCS, Reliance, ONGC and ITC make up for almost 30% of the weight whereas the bottom twenty six stocks contribute to the balance 70%. An investor who goes for index investing is therefore subconsciously concentrating his portfolio even while the index optically gives him a sense of diversification.

INDIVIDUAL INVESTORS HAVE AN EDGE OVER MUTUAL FUNDS:

It is easier for a serious investor to beat the market than it is for a mutual fund as an investor who focuses on stocks can pick and chose his opportunities without help from the general market. A mutual fund on the other hand has to diversify, have some of everything, protect their NAV from large abrupt fluctuations and buy more of a stock from a sector in despair to align their portfolio weights with the overall index weights. They also have

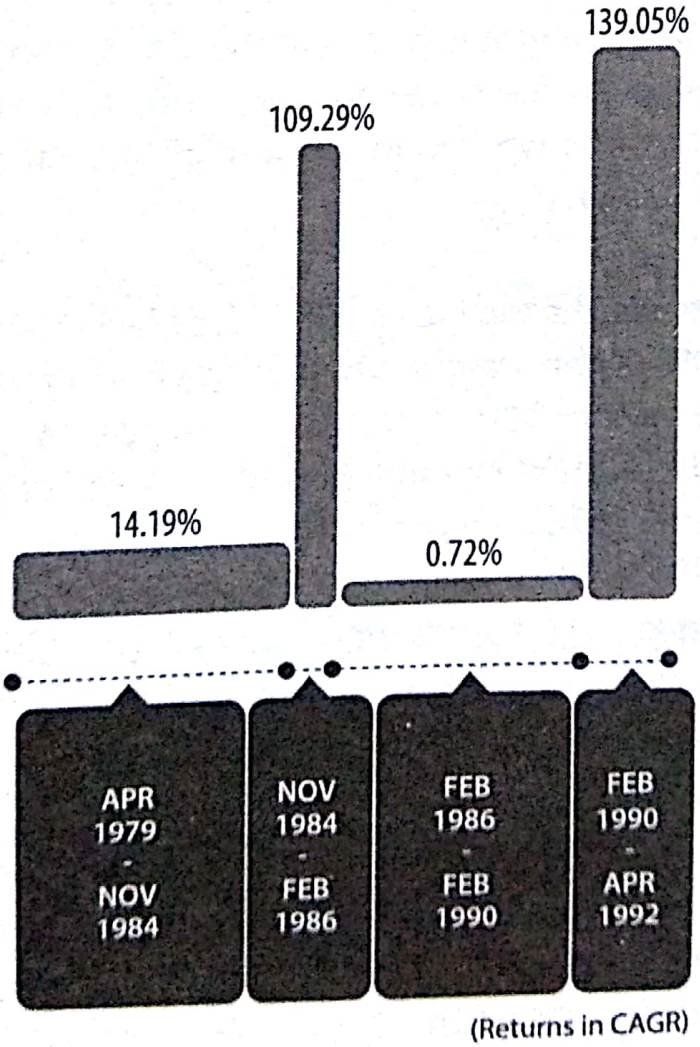
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to focus on liquidity requirements to meet urgent redemption requests. An individual investor has no such compulsions, all he has to look for is the next best opportunity and then load up to the point of maximum comfort.

THE INDIAN STORY:

The sharp rise of the Sensex from 676 points on February 28, 1990 to 4,467 points on April 22, 1992 had booked in years of gains ahead and the broad Indian market traded sideways after that for the next 11 years till 2003. Similarly, the Sensex moved several times between 2003 to 2008 creating many multibaggers and millionaires on the way. Post the January 2008 all time high the Sensex has gone nowhere for the last six years even as many of the investor darlings of the 2008 bull run continue to bleed at between 80% to 95% off their January, 2008 peak.

RETURNS FROM STOCK MARKET INVESTING IS NONLINEAR AND COMES IN BUNCHES.

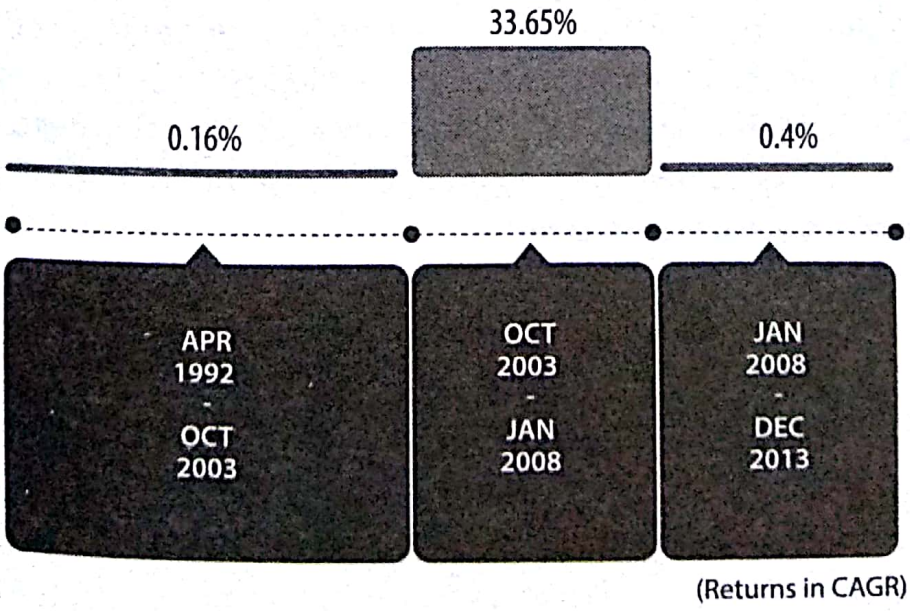


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Investors who run away from the bear generally aren't around to receive the gains when the bull comes along. While it is true that the index provides abnormal returns in bunches the average returns that the Sensex has generated since launch has been 16.7% exclusive of dividends which is better than all asset classes but not enough considering the heart burn and the sleepless nights that an investor had to put up, to generate these returns.

Even while the Sensex did nothing between 1992 and 2003 there were stocks like Infosys which moved up a few thousand times. Infosys wasn't alone as an entire range of stocks from technology, pharmaceuticals and FMCG businesses returned back large, above average sized gains for investors who were smart enough to catch the underlying market theme.

RETURNS FROM STOCK MARKET INVESTING IS NONLINEAR AND COMES IN BUNCHES.



(Returns in CAGR)

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Similarly, in the post 2008 phase while the Sensex has gone nowhere, stocks like TTK Prestige, Page Industries, Gruh Finance & Hawkins Cooker have rallied from ten to thirty five times and are still rising. There was money to be made even if the Sensex was going nowhere as was observed both during the technology bull run of the 1990's and also during the recent rise in consumer, pharmaceutical and private financial stocks.

However, despite the tremendous rise in the sensex from 2003 to 2008 Indian equities have over the past eleven years under-performed gold!

During 1992 to 2003 where the Sensex did nothing even a nominal 12% (that was the interest rate during that time) bank fixed deposits beat the Sensex hands down. From the highs of 1992 till now, the Sensex had returned a CAGR of only 7.5% which is lower than fixed deposits. If this is not long term underperformance than what is?

The Sensex has since inception beaten all asset classes but the coupon on bonds for the first twenty years of this time span was close to 14% so the risk premium hasn't been high. "Thirty three years" is the elusive long term that a person wishing to buy a diversified set of businesses (Sensex) has to wait if he wants to beat all asset classes.

Interestingly, these thirty three years have seen extraordinary bouts of money making with multiple stocks turning out 100 baggers. From Colgate, HUL, ITC, Nestle, Hero MotoCorp, Sun Pharmaceutical, ACC, Tata Steel, Infosys, Zee TV, Wipro, HDFC twins, Bharti, Pantaloon, Unitech, Titan, Page Industries, Jubilant Foodworks, TTK Prestige, Hawkins Cooker etc focused investors trying to bet on a select group of stocks have made money like bandits which emphasises that it has always been a stock picker's market instead of it being a broad-based investment game for anyone wishing to make money - not just in India but across the globe.

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Chapter 04

ATTRIBUTES OF A FULL TIME INVESTOR

When work becomes passion - wealth follows.

'Caveat Emptor' or 'Buyers Beware' is the central theme that runs across the world of investing and one of the basic lessons for an investor who desires to make money from this game is not to rely on hearsay for picking stocks. This hearsay includes stock recommendations from friends and relatives at parties and social gatherings, suggestions from financial newspapers, magazines, television channels and the online portals. More than often, these recommendations are planted after a vested interest has bought the stock and just before he wants to exit it.

The process of making a lot of money from stocks is difficult but possible. The first time investor likes to be on the lookout for what the so called smart investors, operators, large mutual funds and foreign investors are buying, a strategy which when solely relied upon has backfired more often than not. It isn't important to know who else is buying a stock as it is to know why an investor should be buying it and if he doesn't know as to why he should be buying the stock then he has no business being in the game of investing because in this market *making money isn't as important as knowing how to make it.*

A person who isn't equipped to understand the nitty gritty of investing should look out for professional help rather than run the risk of blowing up his money through a few wrong decisions. *If an investor can go to a cobbler for his shoes, a doctor for his illness, a tailor for his clothes or an architect for his home then why not look for a specialist when it comes to stocks?*

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DEVELOPING A PASSION FOR INVESTING:

An investor who has a passion for investing will also develop an endless desire to learn the art of stock picking both from an investor's own action and that of the others. *A prospective full time investor should therefore be absolutely passionate about investing and everything remotely linked to it but being passionate about stocks is a lot different than being passionate about looking at stock prices. Its the research that needs the passion not the minute to minute outcomes.* The investor should become a 'share bazaar ka keeda' (worm of the stock market). However, there is a reverse side to being passionate about stocks which is that unless an investor makes money from stocks he cannot be passionate about it, just like conviction, passion also comes from success, but passion is important to get the investor to stay in the game. *Its like playing test match cricket, if a cricketer bats long enough at the crease, he will make runs but to bat long enough, he needs more skill and less luck, skill comes from practice which in itself comes from playing the game long enough batting at the crease and practising - passionately.*

The non passionate investor will think of stocks as pieces of paper available at a certain price which swings minute to minute depending on both known and unknown factors whereas the passionate investor will think of stocks as ownership rights to a piece of business with a terminal value which could be significantly higher than the current price. Its the process that attracts him to the game while the rewards are there just to keep score.

The passionate investor will try and engage with different people who are related to the business, he will try and know more about why stocks will go up or come down while the non-passionate investor will try to engage different market participants for new stock ideas to know which stocks will go up or come down and by how much.

READING, FLEXIBILITY AND PUTTING REAL MONEY TO WORK:

The first job of an investor is to look for a group of like minded people who are focused on serious investing. Having found a group which is selfless and devoted, the first time investor should also develop a habit of reading, an

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act that has no substitute. He should create a list of books on people who have made it big in the world of investing and try to absorb their investing philosophies to sharpen his own skills at the game. An investor should go through these books slowly, reading it like a text underlining the important points and making notes wherever he feels like. The easiest way to develop skill in the investing game is by being in the market, reading from the past experiences of people who could succeed in converting a limited capital into a retirement fund.

The other aspect of learning the game is to put real money to work and not engage in pure mock trading which is an activity that involves trading with paper capital only. Investors who start with mock trading without putting any real money on the table cannot learn to handle the emotions of greed and fear. Consequently doing well in mock trading has no bearing on an investor's performance when he starts buying stocks with real money. The reason for this differing performance is that while conducting paper trading the investor did not have to encounter the pain of losing or the joy of winning. The fear element was non existent as he was not betting with real money while the greed element was missing as he knew that even if he were to get it right he would not be rewarded with real cash.

Emotions play an important role in helping an investor understand the art of investing. In this case, putting small insignificant amounts of money at work has the same bearing as trading with paper capital. For an investor to learn the art of investing the amount has to be large, significant and meaningful. But as the first time investor stands the chance of losing all that he brings to the table the amount of bet has to be in the overall context of his risk taking ability.

A typical investor chases returns by taking higher amounts of risk. In the endeavour to maximise returns he also maximises risk and thus pays the penalty as beyond a certain level of targeted gain, there is no return but just risk. It happened to me in 1992 when as a young impatient college student I managed to sail into the Harshad Mehta boom wanting to make quick doubles from my investments and though I moved my corpus to ₹70,000 from the initial borrowed amount of ₹30,000 I finally caved in. My desire to earn was significantly more than the urge to learn and hence I paid the price,

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learning nothing in the process except that the stock market is a bad place to be in where rewards come only by luck and not by skill.

BE AN OPTIMIST:

The attributes that make the mental framework of a person desirous of making a career out of investing can neither be learnt nor taught. It is a general offshoot of how the person has been brought up and how he views the world. *Among the many attributes that a person should possess to make a living out of this game is to be an optimist. He has to go to bed thinking that tomorrow will be better than today.* Anyone who thinks that the overall scenario is going to become worse than what it is now cannot hope to hold on to listed securities with a view to making profits out of them. This is because if he thinks that tomorrow will be worse than today then the companies he owns will broadly do worse in the future than what they are doing in the present. Equity as an asset class is valued on the basis of what the business is going to do in the future and not on the basis of what it has done in the past and in the absence of a favourable feel good for the future an investor should be selling and not buying shares.

Despite this, most investors argue, debate and discuss more on the negative aspects of the economy. If stocks have gone up they complain about valuations, if prices are low they complain about the environment, if a stock has gone up and they could not catch the rally they complain of how operators rig the market to ensure that the small investors become smaller, if the stock they own goes up a lot and they booked out early, the fault lies again with the large players who influence choppy price movements which caused them to chicken out. For all the market action a defeated investor always has a complaint book ready. *As a person who intends to make a living out of this business the first thing he has to do is accept responsibility for his action as he cannot be found shifting the blame all the time.*

The investor should learn to love the market and not hate it. A person who loves the market will always be eager to remain in the game and while all participants lose money the winners just have one thing in common, running for them. They were in the game waiting for the markets to turn and for

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opportunities to come and present themselves which does not happen too often but when it does it gives back more than what it takes. *Fifteen to twenty years and three bull markets is all it takes to make wealth from the market and all that an investor needs to do is survive that time period by being in the market continuously rather than coming in when times are good and moving out when they are not.*

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“Companies don't grow at 40% on an individual basis. There has to be a sector tailwind for which such stocks are the leaders.”

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Chapter 05

THE PAIN OF LOSING

Unless you can take the pain, you will never be able to participate in the gain.

The new investor does not realise that stocks are, with or without reason, supposed to fall after he buys it and rise after he sells it. The heartburn of falling prices, to an initial investor after he has bought a stock and of rising prices after he has sold one is much more than what it would be once he assumes maturity and seriousness. With time and experience an investor manages to change the focus from short term stock price movement to the company fundamentals, a change in stance which is gradual and comes with success. However, the momentary pain of losing paper capital puts most investors away from stocks as people prefer a lower consistent gain to a lumpy higher return. *As the pain of losing is always more than the joy of winning, a person on a losing streak is more likely to focus on falling prices than if he were on a winning path not realising that if an investor fears the bear he would never be able to ride the bull.*

EQUATING TEMPORARY PRICE DROPS AS LOSS OF TANGIBLE GOODS:

Stocks do not go up in a straight line and the ones that do, comes down equally fast. The emotion of seeing wealth erode for no reason is a painful stress for all the new investors and most of the old ones. To an investor, who takes local transport from work in order to save money for investing, a 20% fall in price on a ₹500,000 portfolio becomes a difficult proposition to handle. When I had a small portfolio such price drops created a feeling of having been pick pocketed as it took time to understand that such drawdowns were perfectly normal to the life of an investor. The new investor might not be able to take such losses very kindly as each percentage fall in the portfolio value is generally equated with the loss of a tangible asset, for example if the

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portfolio falls by ₹50,000 the investor will engage in self-torture for a flat screen television that he did not buy just to initiate his investment process. The imaginary discomfort from not buying things of comfort even though they were depreciating assets will increase for every subsequent fall not realising that a fall in stock price can be arrested and reversed while there are no such options available from depreciating assets. A stock that falls to ₹20 from ₹30 can always go back to ₹30 and beyond but a car that costs ₹550,000 encounters a permanent irreparable 20% loss the moment it rolls out of the showroom.

An investor who thinks that he should have bought the stock when it went to ₹20 and not when it was at ₹30 will soon understand that tops and bottoms are caught only by fools and liars. *The process of seeing a stock go down is very much a part of an investor's life. It is like falling down for a child while he is learning to walk or being unable to float the first time a person is pushed into the swimming pool.*

Investing is about making less and retaining more rather than making more and retaining less. Sometimes the pain of losing is real and originates from a bad investment decision where the only recourse would be to book the losses and run. Here an investor should remain focused on doing what is right rather than worry about taking losses. Many investors approach this situation with a view to cashing out when they can recover their cost price. *The reality though is that the market does not care about whether an investor gets his original capital back or not. All that it knows is to price the stock on the basis of the available information as disseminated by the collective opinion of the participants.*

THE PAIN OF LOSING IS ALWAYS GREATER THAN THE JOY OF WINNING:

All losses appear permanent till the time they actually reverse the trend because whether the losses are temporary and reversible or permanent and irreversible can be answered only in hindsight. No matter how much an investor is told about not panicking he would start panicking from the moment the stock goes below his purchase price. On the other hand, if the stock moves up the investor experiences an imaginary pain of losing the profits. *Profits to an initial investor do not come with easy recurrence so whenever he finds any of*

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his stock in profits he starts thinking of the loss in this notional profit that he would have to bear if the stock were to go down. The fear of losing profits or making losses creates a negative mindset which compels an investor to think of the consequences rather than the processes and encourages him to focus solely on the price and decide his wins and losses on the basis of daily market movements.

One way of getting around the pain of seeing the stock fall is to buy more of it but as most investors are already invested for their initial allocation the scope of increasing exposure is limited nearer to the lows as lower prices also brings down the self belief and conviction levels of an amateur investor. It is generally a bad decision to average a losing trade though this advice is more for traders but putting good money after bad is another feature of an amateur investor.

An amateur investor's pain is also a relative feature. *It is easier to bear the pain collectively when all his friends and relatives are losing money than it is when he is left alone on the loser's side.* There is a strange sense of comfort in seeing everyone else lose money more so on the same stock or the sector. This works something like the lesser discomfort of failing when the whole class does poorly in a high school mathematics exam than it is when the student fails alone.

The pain is also relative, an investor who moves from a portfolio value of ₹1 crore to ₹1.5 crore might be overjoyed in celebration but a few years later the same investor might suffer much more pain when he moves down from a portfolio value of ₹4.7 crores to ₹4.2 crores. The pain of losing is based on the immediate past set of events. Extending the argument, an investor who is pained to see a stock move down from ₹450 to ₹300 feels settled when the stock stops falling and holds itself at ₹300 because he gets used to new prices on the screen. This sorrow turns into indifference and will again change to joy even if this stock were now to move up to ₹375 which is much less than the price from where it initially started to fall from.

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BUYING WITH BLOOD ON THE STREET:

The common cliché in the market is about buying with "Blood on the Street" but no one suggests as to what an investor should do if its his "own blood" – on the street! The original statement was supposed to mean that an investor should be buying when prices are plummeting because everyone else is selling but a normal investor in such a situation, is already under tremendous pressure as he struggles to manage his original conviction and fights a mental battle on whether to retain or let go of his portfolio. He is short on cash and overloaded with fear and asking him to buy under such circumstances is bizarre. If he were truly convinced in a stock he would have already bought it if not he will just wait and maybe regret his miss after the stock moves up again.

The advice of buying when there is blood on street is subjective and vague. No one can quantify how much blood is enough for an investor to call his broker up, for an investor the first 8% fall can be called blood on the street but what if the market falls by another 18% from there. Generally, the first drop of blood is followed by many more and hence trying to buy at the first sell off could be an aggressive movement into a losing trade.

A better option to exercise in such cases is to let the blood dry and then seek to buy again. Many times a deep market cut does not encounter immediate revival but follows a sideways pattern for several days and maybe weeks before moving up again. It is only in certain random cases that a deep cut is followed by a sharp pull back but irrespective of that an investor should be focused on buying when he sees value and not just because a stock has come down from a higher price. *Generally, in a market decline the stocks that fall are not the ones that an investor would like to buy and the ones that he wants to buy are not the ones that fall making the theory of buying with blood on the street a little more confusing to understand and difficult to execute than what it actually is.* If the bull market has ended then an investor should not be buying the bleeding bull market stocks at all but look at other options as the leading bull market sector faces maximum damage once the party gets over. Conversely stocks that show strength in a bear market do so because their inherent fundamentals are strong and when the next upmove happens such stocks are most likely to make the big move forward.

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Its not just the pain of losing that eats up an investor's mind, an average investor also keeps worrying about the pleasure of not winning from a stock that has not moved from the time he has bought it but if the story is robust and well conceived the gains will be well worth the wait. Sometimes the act of waiting endlessly even in a promising idea isn't such a good strategy as it is thought out to be. One can wait for prices to go up even as earnings are rising but waiting for the company to deliver better earnings is an option that an investor should ignore. *Though stocks are supposed to be valued on promise markets pay on performance. It is much better to buy a stock after it has started to show improved earnings than on its anticipation of doing that.*

WEALTH CREATION NEEDS PATIENCE:

Its easy to sit with a stock delivering earnings growth than to stick with an investment whose earnings are going nowhere. While investors should focus on the long term, sometimes holding a stock which shows no price action under the veil of long term investing isn't the best option for an investor unless the company has been reporting improving fundamentals. A point to consider is Nestle whose stock went nowhere from 1999 to 2005 before rising ten times in the next eight years and Asian Paints which is up more than 2000 times over the last twenty nine years and was up just 3 times for the period 1992 to 2002. Both these companies were doing well despite the stagnating stock prices and hence their investors were in the long term, adequately rewarded for the waiting period.

BORROWED CONVICTION IS DANGEROUS:

An investor who buys stocks on self research is better equipped to handle the downward movement in stock prices than the one who buys stocks on borrowed conviction. While stealing ideas is easy, borrowing conviction isn't and works only as long as the trade moves in a favourable direction. *An investor who buys stocks on borrowed capital is less likely to make a mistake than the one who buys it on borrowed conviction.* The investor who buys on borrowed conviction is more vulnerable to be making a wrong decision by either selling out too early or by holding it too late.

In investing, returns create conviction and conviction generates returns something like the chicken and the egg syndrome but most investors start from the returns side because its easier that way.

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"Making income is different from creating wealth. The former has to be done repeatedly, while for the latter once is enough."

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Chapter 06

RISK VS. RETURN

After 2008, I learnt that it is not what you make that counts but how much you can keep.

Investing is all about the four letter word 'R I S K' and contrary to popular public opinion most investors get rich by avoiding risk and not by taking it. Investments in stocks, bonds, bank deposits and even sovereign debt offerings all carry risk with regard to timely repayment or recovery of either capital, dividend or interest though the degree of risk may vary depending on the instrument and the entity backing it. The risk to return equation is generally assumed to be linear for any sort of economic activity but an astute investor seeks to remove the linearity in this equation by maximising returns for a minimum level of risk. An investor who does not understand risk and has no method of controlling it has no reason to be investing in stocks or in any other market providing uncertain payoffs.

ALL ASSETS CARRY RISK:

Each investor's risk-reward profile is unique to him and determines the avenues of parking his excess funds. An investor's options for deploying cash is diverse and ranges from putting money in RBI bonds, public provident funds, liquid mutual funds, bank fixed deposits, AAA+ rated paper, precious metals, direct equity, mutual funds, engaging in open ended derivative contracts, speculating on horses, gambling on the roulette table or by purchasing lottery tickets. At the bottom of the risk - reward tradeoff table is investing in government bonds, however central banks have defaulted before and so have sovereign governments. Argentina in the 1990's is a prime example of this while the United States Federal Government has been reported to have gone bankrupt by the Emergency Banking Act of March 9, 1933.

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In India, bank fixed deposits are guaranteed only up to ₹100,000 only, while companies with AAA+ ratings are no holy cows and have been known to default but investors still buy them because of the perceived safety and it is not uncommon knowledge that stock market investing either directly or through mutual funds come with their own risks. In 1980, gold fell almost 40% from its highs, after a multi year bull run and did not cross the 1980 peak for the next twenty eight years. A writer of open ended options agrees to take a very high risk for a small upfront payment and so does a gambler who bets on horses where his money multiplies several hundred fold with one right move and evaporates on a wrong one. This equation extends to the roulette table where the right number can get a speculator 35 times of his capital in less than a minute of waiting. Such an effort would need a little over forty six years to be accomplished on a bank fixed deposit running at 8% annually and finally, if an individual is lucky a ten rupee lottery ticket can fetch a ₹10 crore jackpot in the Bhutan bumper lottery competition.

RISK CONTROL IN 2009:

Personally, my investing strategy took a complete 'U' turn after the 2008 sell off where at one point of time I was looking at a near 70% portfolio destruction from the January 2008 highs. Even though I could control some damage by sticking to names like HDFC Bank and Titan the loss was more pronounced because of my leveraged positions. As the cascading fall of stocks in October 2008 created a continuous bonfire of currency notes all long term theories were going for a toss especially for someone like me who remains more than fully invested - always.

In March 2009, somewhere near the trough my mind started suggesting that I have had enough and the need of the hour was to get the money out from the markets. I have noticed that my panic invariably marks the end of a bearish phase most of the time, so as I sold some Titan I was enveloped in a new sense of discomfort. Selling stocks that were going down in price seemed as bizarre a reason to justify but the extent of foolishness multiplied itself after I started raising cash and not before it. The bank fixed deposit would have generated a pre tax return of 8% whereas there were many stocks available at a yield of 5%. I quickly reversed my trades and was now looking for the yield stocks.

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Getting a yield isn't enough. What an investor needs to is to look for a stock that will grow with the yield and I started looking for the high yield, high RoE low P/E stocks.

The process was simple, all one had to do was run a screener with a few filters and short list the names depending on the level of business understanding. I sold off my HDFC Bank and some Titan shares to buy several of the beaten down names like Voltamp, Thermax, Blue Star etc. The logic was something that I used to refer as the 30-5-5 method. It was buying debt free companies having a RoE of 30%; available at a P/E of less than 5 and selling at an yield of 5% or more.

The logic of this 5% yield for debt free companies where the payout ratio was less than 50% was that while the dividend would protect the downside the high RoE would assure a P/E expansion whenever the cycle turned. Over the next few months just as the cycle turned these stocks moved up by two to three times to reflect the improved sentiments on the street. I could bet hard at that time because I managed to control the risk through the yield though the original idea to look for yield companies came out of the fear of losing it all.

The risk at the depth of the 2008 crisis was maximum but then investors who got in at that time made the maximum amount of money. *One interesting attribute of investing is that an investor who is convinced of a story generally gets in too early or misses out till the very end.* So even if Titan fell to ₹34 (adjusted for bonus and splits) in March 2009 from ₹87 in January 2008 and is up 7 times till November 2013 over its March 2009 lows the ones who were convinced of the story would have got in at ₹45 to ₹50 and watched the stock sink another 25% rather than wait for the lowest point on the screen before initiating their buy.

For high quality businesses it makes sense to be a little early as their recovery is assured whereas for low quality stocks it makes sense to be a little late after seeing the first signs of recovery as these companies work with undefined timelines.

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PRICE IS A FUNCTION OF RISK:

As the stock price discounts events before they happen, valuation is actually at its lowest point when risk is perceived to be maximum. If everyone knows of an impending event, the event doesn't become so significant from the stock market point of view as prices would have moved in anticipation of the event much before it actually happens.

In 2008, even though the markets had discounted the U.S housing problem, it fell severely in October because the Lehman collapse was sudden and unexpected. The fact that a stock could be good at a price for all kinds of known risks escapes the thought process of most investors. One way of evaluating whether a stock has discounted the worst is to see if the worst is being debated on business channels on a regular basis. *If the level of debate and discussion is continuous and intense with a greater proportion of commentators anticipating the same then the market would have said to have discounted the worst and will probably move up after the event and in case the worst does not happen the upmove that follows it will be sudden and sharp.* Many people defer buying stocks when there is perceived risk arguing that they would buy on clarity but the collective wisdom of stock market price discovery is such that when there is clarity the stock price will also move up to reflect the new found clarity.

The reason why stock prices discounts the bad news well before the event is because as the news of the anticipated risk spreads around, people who wanted to sell do so before the event thus when the actual news hits the market there are a very few shaky sellers left to push prices down. Similarly, if the market is anticipating a burst of good news then the buyers rush in to buy in anticipation of the good news itself so when the news actually hits the market there are very few buyers left to take prices up. No wonder most participants believe in the adage of buy on rumour and sell on news.

Investors should love the risk that is presented to them because a large macro risk first moves into the stock price and by the time it comes to the investor it is probably too late. In this market, investors don't get rewarded for the known certainties but an investor does get penalised if the known certainties do not

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happen as per the market's expectations. On the other hand, no one gets paid for betting on something that is already making headlines. How could a buyer of securities not be aware of a newspaper headline which the proposed seller has just read or vice-versa is a question that all investors should keep asking themselves?

The next question to ask is if risk is already priced in what is the risk to an investor who puts up his money upfront. *Risk to an investor in listed securities comes from not knowing what he is doing and from being unable to anticipate sudden unexpected events.* What makes buying lottery tickets or betting on race horses or playing roulette so dangerous is that the results cannot be predicted upfront with any degree of surety. Amateur gamblers do not understand this and put large amounts of capital to work which risks their ability to survive this game for longer periods of time. A professional gambler on the other hand will spread themselves thin and wide so if one bet goes against him the other one comes to his rescue and he does not go belly up from a single bad decision even if the actual outcome was different from what he had originally anticipated it to be.

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“Focusing too much on the purchase price is one way to remain in love with a stock that does not care who its owner is.”

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Chapter 07

BUY WHAT YOU SEE

More often than not, the popularity of the stock is always preceded by the popularity of its product - a signal most investors tend to miss.

This is my favourite stock analysis theme and is dedicated to Peter Lynch, the original proponent of this theory. As a consumer of different products an individual is introduced to various investing ideas each day and even though he has a first hand knowledge about the products that he uses he generally prefers to buy stocks of companies producing products he has little idea about. The underlying theme of this approach is that a retail investor will find it easier to decipher the success of Britannia's new strawberry flavoured cream biscuits than to understand the robustness of L&T's foray into manufacturing anti aircraft guns. The simple things in the stock market are the most difficult to do, even though it was simpler for a person to buy a biscuit manufacturing company for a 250 times jump in the last 30 years or a paint company for a 2000 times jump in the last 28 years very few people actually did so because companies that manufactured biscuits and paints did not look as classy and demonstrative as buying a company that was growing shrimps or engaged in the business of generating renewable energy. What's so special about biscuits or paints as a product would be the argument? Well, nothing except that simple businesses make more money than complicated endeavours. Even after pouring in tons of cash, ITC's biscuit division has not been able to make any serious dent on Britannia's sales nor have all the MNCs together managed to dislodge Asian Paints as the leader in the paints business.

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SATISFIED CUSTOMERS GENERALLY LEADS TO SATISFIED SHAREHOLDERS:

The user of a product invariably finds ways to justify not buying the company whose products he frequently uses. An investor who rides a Hero Honda to work normally buys shares of a TVS Motors as he is attracted to it as a low priced, low P/E stock.*The investor in this case fails to realise that if a product sells well to satisfied customers it will have satisfied shareholders as well.* No wonder very few people bought Eicher Motors a stock that is up 100 times since 2002 even though Royal Enfield was the much sought after bike in India and Volvo buses became the preferred vehicle for long distance travel. *Alternatively, if a product has unsatisfied customers then the level of shareholder satisfaction over a period of time cannot be too different.*

My initial days of investing were spent in several such biases. In the late 1980's as a family business we were supplying gypsum to ACC and we were well versed with their new requirements for gypsum and hence with the operating trends of the company. However, as the elders in the family regarded stock market as a gambling den we never looked at ACC from the stock market point of view. Today, when I sit back and think we would have made several times more money buying the stock of ACC which moved up around 40 times between 1989 and 1992 than by digging the mountain for gypsum.

My father used to frequently visit the Maharashi Karve road office of ACC during that time but he was never eager to buy the stock or even look at it though we often got calls from relatives and friends for a scoop of some inside information. In due course, when I entered the market I was betting on Hindustan Motors and Reliance Petro instead of ACC. ACC the leader of the bull market looked very expensive against the smaller priced duds.

More often than not, the chances of a person making more or losing less, enhances from buying a stock of the company he is connected with whether as a vendor, employee or a customer. While most Tanishq and Jockey franchises have done well for the past several years they have come nowhere close to what the shareholders of the company have made. Irrespective of the agreement a company will never let its dealers, distributors and franchises earn a higher Return on Equity (RoE) than itself and in the long run shareholder returns are determined to a large extent by the RoE only.

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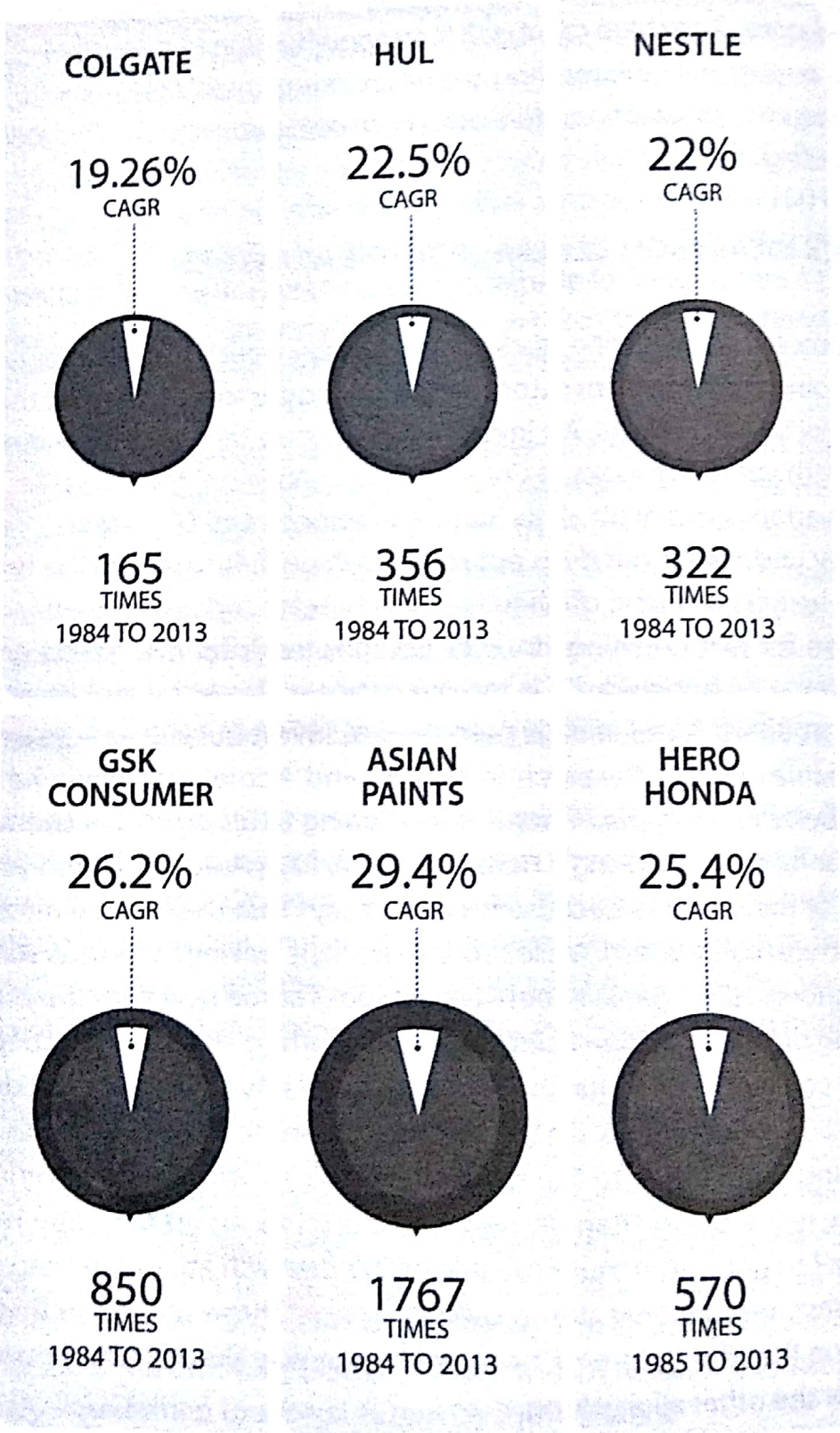
Similarly, an investor who used ACC cement while raising the walls of his first house buys JK Cement because his friend's brother thinks that investment in JK Cement has a better potential, a person who drinks, Mc Dowells No. 1 whisky buys a Tilaknagar Industries because McDowell is already a high priced stock. 'How high can it go?' is an apprehension responsible for causing more opportunity misses than any other. *Except under special circumstances of extreme overvaluation, stocks can keep going up as long as earnings keep expanding.*

STOCK IDEAS FROM GENERAL ROUTINE ACTIVITIES:

The process of identifying stocks from everyday work is simple but is regularly overlooked by most investors as they struggle to do complex things to achieve simple returns. An investor wakes up in the morning and brushes his teeth yet never looks at Colgate as an investment idea; he takes a bath yet overlooks HUL with all its Sunsilk shampoos and Dove soaps; he wears Jockey underwear but does not research Page Industries. On the breakfast table he gets a couple of biscuits; some Nescafe coffee and keeps scolding his son for not finishing Horlicks yet ignores Britannia, Nestle and GSK Consumer. In between, he is receiving calls on his Airtel mobile yet never looks at Bharti Airtel. If he is permitted to invest outside he researches all companies except Research in Motion and Apple even while he uses a BlackBerry or an Apple i-Phone. If he is going to his office in a two wheeler or a car he could be using a Hero MotoCorp, Bajaj Auto or a Maruti yet never looks at these stocks because his broker says that they have already gone up and are highly priced. While in office he keeps looking at his bank statement but ignores HDFC Bank; in between he looks at the new high rise buildings getting painted by Asian Paints but like the others skips the investing angle to the product. During lunch, he grabs a quick bite at Dominos but does not buy Jubiliant Foodworks. On the way back home, he is reminded of his friend's wedding and rushes to the nearest Tanishq showroom but overlooks to initiate research on Titan. At home, he switches on his favourite business channel to get a 30 minute capsule of the day with an intention to pick on the latest nuggets that the so called "experts" throw at their audience not realising that the goldmine he is looking for was already with him in some form or the other all day long.

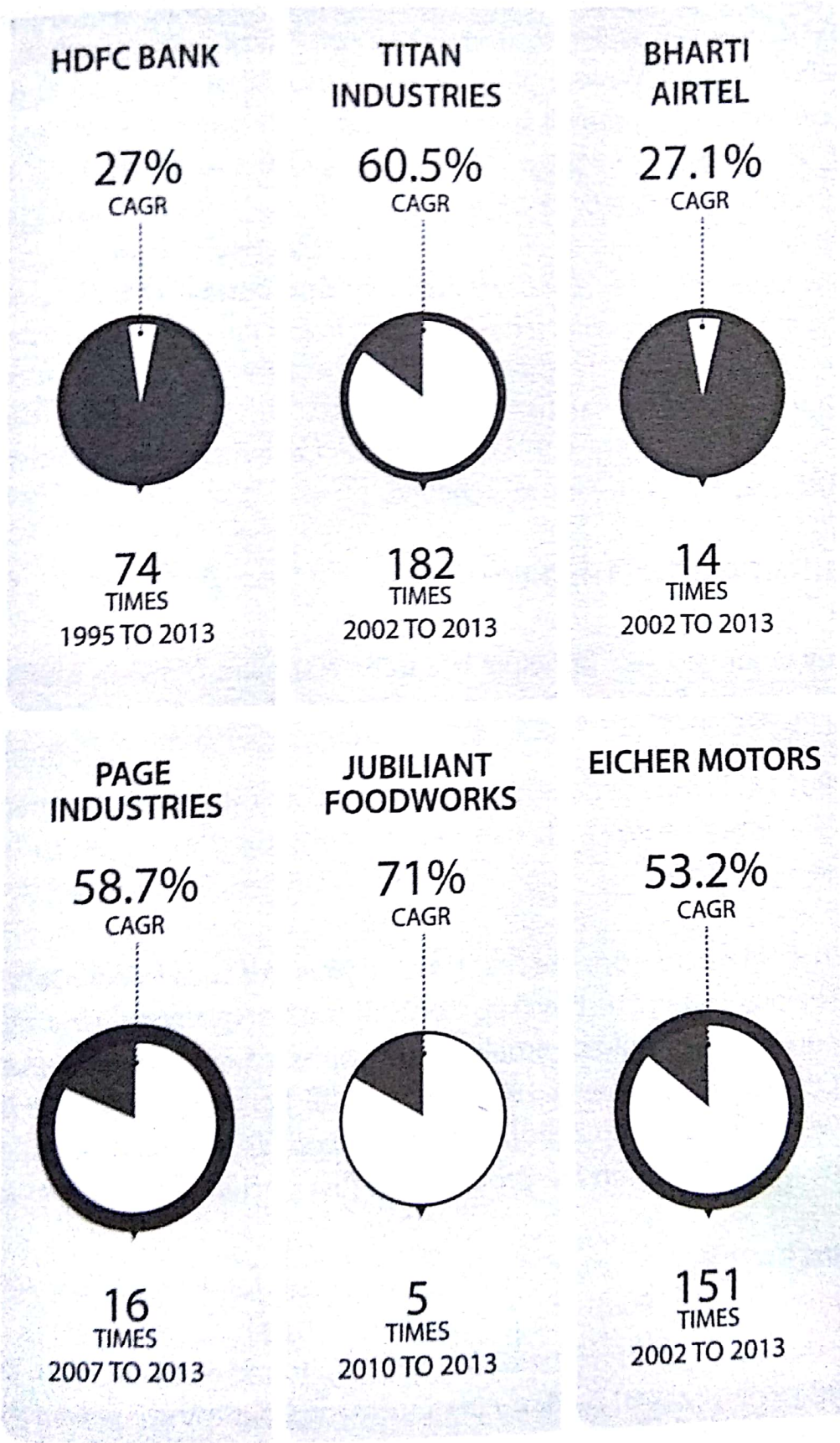
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THE RETURNS FROM THE 'BUY WHAT YOU SEE' STRATEGY HAS BEEN STAGGERING



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CAVEATS FOR THE 'BUY WHAT YOU SEE' INVESTOR:

Just because an investor likes the product does not mean that he should buy the stock as being a loyal customer for the product should just initiate the process of research which should not be construed as a conclusive signal for buying the stock. When a person starts liking the product he should look at the package of the product for the manufacturer's name and if the company is listed, the customer might well be standing on the doorstep to becoming an accomplished investor. *Personally, I stumbled on Jockey this way and the stock is up some 15 times till November 2013 from when I bought it in March 2009 and could move up 10 more times in the next decade if the company can do in the next few years, what it has in the last five.* If the company is listed and the product is one which appears to be in demand the analysis moves to stage two; where one has to check the valuations. Even here it is mostly better to buy a company with a great product at a higher valuation than to buy a bad product company at a cheaper price.

SAFEGUARDING THE THEORY:

The 'Buy what you see' principle has been a subject of much debate and discussion but suffers from two interpretational flaws:

a. Buy what you see does not mean that an investor should immediately buy what he sees. This should be construed as a lead to further analysis only.

b. The time gap from the first time an investor sees these products to the point where he buys the stocks of companies manufacturing these companies should be small. For example, if an investor first noticed a Colgate toothpaste in 1982 and is contemplating to buy it in 2014, it would not be such a profitable thing to do as it would have been had he bought it when the product had just started to become popular.

MY OWN STORY:

In the year 2003, one of my students came up to me and wanted to know if I had been to Big Bazaar? As *'Burra'* in Hindi means 'big' my immediate thought

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was that the word Big Bazaar was the English translation for *Burra Bazaar* which is one of the oldest and most populated market in Kolkata. But Big Bazaar was the name of a hyper market chain selling all kinds of daily use items. On further enquiry it was clear that Big Bazaar was a part of the listed company 'Pantaloon Retail' now known as 'Future Retail'. At that time Pantaloon traded at a market cap of ₹90 crores which was just 0.2 times its sales; PE of 8 times and growing at almost 100% year on year while generating a RoE of around 18% only. The company was generating negative cash flows and needed fresh dozes of equity and debt to grow and was managed by promoters who were overly ambitious for their means.

One look at the figures and it was clear that this was not going to be a low risk investment nor was it going to be a low reward bet either. There was a McKinsey report which suggested that organised retailing would become very big in India and I was desperate to ride the story. *When the inner conviction is strong an investor finds a hundred reasons to buy a stock and when the inner conviction is weak then an investor finds a thousand ones for ignoring it.*

I visited Big bazaar on a weekend and the crowds told the whole story, prices were low and people were queuing up to buy, one more visit and it was clear that Big Bazaar was a hit. It was time to look at the other format the departmental store 'Pantaloons'.

The Pantaloon departmental store which was engaged more in garment retailing was located in Camac Street, the heart of Kolkata. This store was located just adjacent to 'Westside' a retailing venture of the Tata group owned Trent Ltd. The balance sheet readers would have put Trent as the winner as the stock traded at a market cap of around ₹200 crores; a PE of 12; dividend yield of around 3.4%; cash on balance sheet of more than ₹100 crores and a RoE of 9%. Trent looked a much better investment option than Pantaloon Retail.

With a bulging cash on balance sheet and no debt, Trent was more about in-house labels, higher margins, calculated growth, sound management and a strong dividend yield. *On the other hand, Pantaloon had all the negatives when it came to balance sheet analysis with its high debt, low margins, negative*

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cash flow and questionable accounting practices. Informal whispers were already debating as to how long the Pantaloon bicycle would roll on without toppling over.

The more I looked at the two companies the more confused I got. The crowds could be seen at Pantaloon whereas the financials of Trent looked better.

To check and cross check I would stand for long periods of time outside both the stores and count the number of people walking out with shopping bags and Pantaloon beat Trent by an overwhelming majority. I used to walk half a kilometre away from the stores and would check from the pavement walkers for each of the stores. More people knew about Pantaloon while only a few were aware of Westside while in a taxi, the driver was more likely to know about Pantaloon than about Trent. It was clear that more people were shopping at Pantaloon.

Despite this, I put more money in Trent than on Pantaloon knowing fully well that Pantaloon appeared to be a better bet. I was really convinced of the retailing story and did not want to miss the theme at any cost so bought both the options as at that time the crowds at Pantaloon competed with the balance sheet of Trent for a part of my portfolio allocation and though I decided to favour the balance sheet at first, I rectified the mistake by going with the crowds later on. Over the next 36 months, Pantaloon was up 45 times whereas Trent moved up just 6 times.

It was difficult to hold Pantaloon. In a couple of months of buying the stock, it doubled and there was an urge to sell. It doubled again in the next few months and I was sitting on a 4x in less than six months of purchase. The pain of holding accentuated by the fear of losing all the paper profits played havoc. Friends, relatives, well wishers had just one suggestion "Sell the stock or if not the full quantity sell as much to get the cost for the balance quantity to zero".

I continued to hold while looking to add aggressively whenever possible. As I was running on leverage from advances on shares my power to invest out of borrowed capital increased with every rupee rise in my portfolio. *For me*

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it was a game of high risk for high reward. I either wanted to hit the home run or have nothing and there were no questions of half houses here. The portfolio went on an exponential growth path aided by rising stock prices coupled with mindless leveraging. By January 2008, the home run in Pantaloon had been hit as the stock adjusted for splits and bonus was up 125 times.

These things happen by chance and not by choice. The next big opportunity could come anywhere but the easiest place to spot for a retail amateur investor is in stocks which he can track on an ongoing basis. *Once off the starting blocks, most of these 'Buy what you see' stocks get into long trends which run into years and even decades.*

A company with negative cash from operations is more likely to see a trend break than one which has a positive cash from operations. So even if an investor is late he still has the possibility of making decent money in stocks if the cash from operation is positive than if the cash from operations shows a negative figure but if the sector is in a bull market then valuations do not matter and markets like to back up a company which shows a higher revenue and profit growth than to a company that is just accumulating cash. The Pantaloon story stopped as it was negative on cash flow whereas another competing retail play Trent could not continue to grow for long as it also faltered on the cash from operation yardstick but the jewellery retailer 'Titan' went up more than 150 times from its 2002 lows just because it was able to generate profitable growth with a positive cash from operations.

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“Making $1,000,000 from trading naked call and put options happens only to one in a million, the others just go home - naked.”

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Chapter 08

MACRO NUMBERS – HOW MUCH TO ANALYSE?

A person who can endlessly talk and worry about global and local macros can become a good investment advisor or a commentator but not necessarily an accomplished investor.

In this new age phenomenon of internet, business channels and pink papers the daily bombardment of various data points has made life difficult for the general investor. He is compelled to spend more time on things that need less attention. The time that an investor spends in discussing unpredictable macro trends is inversely proportional to the time he would have for doing other useful things. A small investor who has no compulsion to come up with macro economic analysis should therefore avoid reading these statistics beyond a point.

Macro number analysis is suitable for those who engage in commodity and currency trades or for those who deal with a top down country approach across geographies and asset classes but extended discussion and analysis for a small investor engaged in a buy and hold strategy of specific businesses isn't as useful as it seems on first glance.

JUST STATISTICAL NUMBERS:

Most macro numbers are statistical data which represent mere changes from a base and tell us little in absolute terms. The new number becomes a base for the following year as the trend of comparing a number from the preceding period continues endlessly.

A strange attribute of these numbers is that these numbers would be the weakest when the markets are making a bottom and appear the strongest when they

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are making a top. In January 2008, when the Sensex made its peak India had a current account surplus with low inflation, low interest rates and a GDP that was growing at around 9% but still the markets collapsed whereas fourteen months later in March 2009, the economy was reflecting a weak set of data all throughout but the Sensex made its bottom to bounce back. The reason for this anomaly is that these numbers are statistical data points so the weakest set of economic data creates a low base while a strong set of numbers raises the base for the following period. *As an economy encounters cyclical swings it gets from a situation of 'it can't get worse from here' to a point where 'it can't get better from here'.*

However, the print and electronic media look upon these numbers as a news-point that can draw in eyeballs for people to tune in and watch the data as it is unveiled. This data presentation is followed by hours of number crunching, debates and discussions where talking heads are invited to present their views and analyse events. Investment options exist all the time and when the time to buy arrives most investors find excuses to hide behind these broad headline numbers. In bear markets, most investors are discouraged from buying stocks when they are at the most attractive point because of the negativity that these broad macro numbers reflect at that point of time.

In this barrage of number crunching, people forget that it is only the minority owners of listed stocks that like to base their investment decision on these numbers. A large sized trader at Chandini Chowk would do nothing differently just because a certain macro number has come in a certain way but the passive owner of much larger and efficient business (shareholders of listed entities) will be tearing their hair trying to forecast the actual impact of these numbers. Most investors love to talk on the monetary policy stance of the European Union than about the prospects of a company that they own not realising that the time devoted to unrelated macro number crunching reduces the time available for conducting serious individual company research.

However, it is incorrect to suggest that all macro numbers should be discarded from the realm of analysis. Certain broad macro trends help an investor in identifying the next big theme. For instance, a confluence of 6th Pay Commission, farm loans waiver and the implementation of the Mahatama Gandhi National Rural Employment scheme initiated a big bull market in

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consumer stocks from 2009. Similarly, the Food Security Bill will increase the disposable income in the hands of the rural population by giving them rice and wheat at subsidised rates. An analyst has to then estimate the items that are under penetrated in rural India and identify the companies manufacturing them. Of course, this is not the end of the analysis but it does provide an investor with some basic guideposts to start looking from.

MACRO DATA IN INDIA IS UNRELIABLE:

Another problem with these macro numbers especially in India is that they are highly unreliable. An investor needs to focus on the broad macro variables at hand rather than look at them on a day to day or a week to week basis. Once a number has been released, corrections keep happening for several months ahead so relying on a deceptive number is itself a debatable argument. In the Indian context, some of the numbers like the Index of Industrial Production (IIP) shows wide dichotomy with reality. The IIP index till very recently had items like black and white television, typewriters and video cassette recorders. Surprisingly, typewriters had a higher weight than window air-conditioners which expanded the tracking error making it futile to put greater reliance on these numbers.

Another aspect that reduces the importance of tracking macro numbers in India is the prevalence of the parallel black money economy which sometimes fails to get captured in the overall economic number game but nevertheless influences the overall level of economic activity.

PASS THROUGH COSTS:

Any event that affects all the players of an industry should in most cases be ignored. *That is because if everyone gets equally impacted then such an event does not change the relative competitive positioning of the business and hence no single company gains or loses with respect to another. Good companies get across ways to manage broad macro economic issues by passing the costs through to the ultimate customer.* Industry events do not matter unless the government intends to kill the industry as it happened with the jewellery retailers. One classic example is of Asian Paints whose critical input is crude,

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if someone told an investor in 2002, that crude will be up 8 times over the next decade he would have rushed to his broker to dump the stock but during this period Asian Paints has gone up 30 times in spite of the rise in price of crude oil. As a rule, a long term investor should not get too worried because of rising input costs or a new tax on the finished product or any other news flow which affects the industry in general rather than his company in particular.

ANNUAL BUDGET:

Another big hoopla is the annual budget. The real driver of this frenzy is the media which has its own intentions but as argued above all budget provisions are industry wide events and don't affect one specific company over another. *Generally, budgets have a limited shelf life and good companies continue to do well with bad budgets whereas bad companies struggle to deliver even with good budgets.*

POLITICS:

India has been running a coalition government right since 1989. In this period, the Sensex has moved up more than thirty times while several stocks have run up a few hundred times. Just like the budget, good companies continue to do well in spite of bad politics and bad companies will fail to deliver even in the best of political climate.

However, there is nothing like getting a stable government but as populism and politics go hand in hand, a government can only be as intelligent as the people who vote it to power. Moreover, the fragmented nature of the political setup makes one believe that India might find it very difficult to have a single party government anytime soon and so an investor will have to pick his spots so that he can perform inspite of the government not because of it.

GLOBAL LIQUIDITY FLOWS:

The global liquidity tap of quantitative easing initiated by the dollar printing exercise of the U.S Federal Reserve and categorised as QE1, QE2 and now

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QE3 provides a great deal of information on how the newly printed dollars would go on to affect the different asset classes. History shows that bull markets start in the backdrop of sustained money printing and thrive on low interest rates under a high degree of speculation and leverage. Once that the cash has been printed it will seek to get into an open ended dream; something that was quite evident when Alan Greenspan released liquidity during the late 1990's which chased NASDAQ stocks and then the U.S housing market. The Fed by artificially keeping interest rates low indirectly channelled this liquidity into gold and emerging market stocks in 2003. The current tap of money printing still keeps chasing gold and till the time the Fed is in a easy money state the yellow metal will continue to bloom.

The general argument is that liquidity chases an asset class but in reality liquidity will always chase that asset class which is backed by some degree of fundamental reason and appears attractive from the investment point of view. In addition to having a tailwind behind them the asset class in demand will either be new or heavily under-owned.

In other words, fundamentals attract liquidity leading to higher prices, if liquidity was chasing internet stocks it was because internet had great potential for growth. Gold was being chased in 2003 because people were unsure about the U.S dollar and also because the yellow metal was the best hedge against the inflationary policies of the Federal Reserve.

While it is certain that liquidity printing leads to inflated assets but the key challenge remains to pinpoint the asset class that the fresh liquidity intends to chase. *As a macro observer one has to wait for the asset to make the first move and then jump in rather than jump in and then hope for the asset to make the move.* For instance, the asset class that hits a high for the first time after the liquidity tap is opened up will continue to hit newer and higher highs thereafter. It makes sense to leave the first part of the rally to the serious risk takers and smart participants should prefer to be paid a little less by being a little late than try and make a little more by being a little early as a trend that starts with the inflow of liquidity does not stop soon but extends well beyond what normal analysts can forecast.

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THE FOREIGN MONEY IN INDIA:

The Indian markets are driven predominantly by inflow from foreign investors as the local retail participation is abysmally low. A typical problem with our economy is that a year of strong foreign inflows is followed by a year of strong inflation as there are no channels to put this liquidity inflow to use. A strong inflation leads to higher interest rates which has its own consequences on the market. As India is predominantly a current account deficit country these foreign flows are needed to get over the external deficit issue but what the country needs is more of foreign direct investment or FDI rather than foreign portfolio investment because the portfolio investors are more nimble footed and are eager to exit on the first signs of trouble at a time when the domestic country needs their capital the most. FDI however is more durable and long term in nature as it isn't easy for Pepsi to leave India as it is for a Morgan Stanley to sell its Indian stock holdings.

No matter how much investors argue about the theory of a stock moving up on earnings the real driver of stocks in India are the Foreign Institutional Investors. While the domestic mutual funds are limited in size and the local retail participation almost negligible, stocks that come under FII fancy are quickly bid up to several times their earnings. In this context, one has to understand that irrespective of earnings, stocks that hit the FII ceiling limit find it hard to move ahead in price and consequently enter a phase of long sideways price movement where the extended valuation gets into a sustained correction mode. Jubilant Foodworks is one such stock as the company, according to the December 2013 filings with the BSE, has a promoter shareholding of 49.9% while the FIIs make up for 47.38 of its ownership. This leaves less than a 3% float for the domestic investors who in any case are never interested to buy the high P/E stocks. If the FII were to buy further shares they would have to look out for the promoters to sell out to them. This kind of a shareholding structure puts the stock price on a long grinding correction as unless the price corrects it would not find support from domestic investors and the FIIs are in any case capped from making further investments.

Another problem with a stock that has hit the FII ceiling is that trade between one FII to another happens at a premium. While such a trade is good for the existing investor it discourages new hands from getting in as the trade brings

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an immediate impact on the NAV because the fund portfolio is marked on the general market price and not on the premium that has been paid by the acquirer.

Most of he high priced quality stocks are FII favourites and once that ceiling gets hit an investor should sit back and reconsider because with over $150 billion and an incremental inflow of $20 billion to $25 billion each year, the foreigners remain the most potent force of stock price movement.

Overall, macro number analysis is a never ending task but after an investor has gone through the basic set of data, incremental research adds very little to his ability to take informed decisions. While the desire to research each piece of macro data is a natural consequence the benefits from such an incremental effort drops with amazing speed and finally, if an investor predicting on the basis of macro economic numbers is consistent than who knows some day he might well be right.

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"Given an option between good results and a stock moving up, an investor should settle for the former - any day."

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Chapter 09

INTRINSIC VALUE - THEORY AND PRACTICE

Its easier to hold a stock after it drops 10% from the price that a person bought it than to buy it after it moves up 10% from the price an investor first thought of buying it.

Long before Indians were introduced to the world of investing, John Burr Williams gave investors the concept on evaluating the intrinsic or fair value of a stock. Williams stated that the intrinsic value of a stock equals the discounted value of future dividends plus the residual value of the business. In other words, one had to predict the future dividend payoffs and then bring it to present value by discounting it with an appropriate number. Discounting is the process of equalising the purchasing power of a rupee to be received later in the future to its current value. For instance, if prices are expected to rise 10% every year then the value of goods and services that can be bought for ₹100 one year later would need only ₹90.90 to be purchased today.

In case of a company not paying dividends for now Williams argued that the intrinsic value will be the future payoffs when the company actually starts paying dividends. In case of companies that retain and invest a large part of the present cash flow for future payoffs the intrinsic value will be the present value of the residual cash (as discounted by an appropriate number) whenever the company is ultimately liquidated.

This argument suggests that a company which does not pay a significant amount of dividend in the current phase should pay a higher dividend in future if this is to be valued ahead of a company that is paying dividends and that companies that do not generate enough surplus for distribution to their shareholders should therefore be valued lower. This is primarily the reason why cash guzzling, asset heavy, negative cash flow companies like cement, steel, oil

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and gas etc are valued cheaply to the cash distributing asset light businesses like consumer, pharmaceuticals and IT Services.

This theory can be employed only for businesses having a tremendous amount of predictive power and hence is inapplicable for companies that cannot be forecasted for future economic trends as forecasting a dividend payoff from a copper mining company would require estimating the future price of copper for the next several years. Had an analyst been so competent with his forecasting ability he would have been trading copper futures on LME rather than changing data on an excel sheet to get to a number which he thinks is an appropriate value for a business with multiple variables.

AN ASSUMPTIONS BASED VALUE IS DIFFERENT FROM THE MARKET DETERMINED PRICE:

The concept of valuing companies on dividend discount basis even though appreciated and accepted by the investing community is indicative and not a conclusive formula for evaluating the price of a stock. *Ultimately the price of a stock is governed by what the buyer is willing to pay and not by what he should actually pay or by what a seller is willing to take and not by what he should actually take.*

While markets pay for future earnings most assumptions in a stock valuation model are made keeping in mind the financials of the present or the recent past. It is this dilemma that makes investing such a complex game to engage in. There are no right answers here as the entire analysis is based on a minefield of broad approximations based on a set of moving economic data and an investor who focuses on getting the direction correct will do better than another who tries to work with precise numbers. Investors who focus too much on getting the right value of a stock have to realise that investing is not science and prices are governed by emotions as well as by reasons. In times of a bear market the negative emotions on the stock pushes the price below the intrinsic value whereas in case of bull markets the optimism of the participants pulls a stock much beyond the intrinsic value.

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The intrinsic value is thus reduced to a reference point, a guide post or a milestone at best which in all probabilities will be crossed on either side because of the overwhelming factor of human emotion in stock price discovery.

The market price of a stock is established by the forces of demand and supply or by multiplying the EPS with the P/E. There is no constant P/E number for a stock and trying to forecast the exact P/E ratio is at most times a futile exercise much like a single attempt effort at catching a bouncing ball with blindfolded eyes in a dark room. All that an investor can predict is whether the P/E is high or low; as he can as to whether there is ball in the room or not. However, predicting as to how high a P/E can go or how low it can fall are items of academic interest left for hindsight followers only. *This is because the P/E ratio of a company is about the overall perception as to where the company's earnings will move in the future.* A company whose earnings are perceived to be depressed for the future will see a drop in perception (P/E) likewise for a company whose earnings are expected to be buoyant for the future will see a rise in perception (P/E). Even though investing is not science, a momentum of expanding or contracting perception (P/E) remains that way unless an external force (catalyst) is applied to change that perception.

The primary driver of price is earnings but the secondary and almost equally powerful driver of prices are the perception of those earnings. *Most investors look at present earnings and try and judge how much the earnings will move in line with the future but the right to remain rich lie with those who can predict how much the stock price will move in relation to those earnings* as many can forecast the earnings but its only a few who can guess on the approximate P/E that such an earnings would command.

GETTING FIXATED WITH SPECIFIC NUMBERS:

In the quest to over-analyse, a serious investor sometimes spends a little more time predicting intrinsic values and goes wrong not in the method of computation but in the assumptions that he makes. A new investor would try to get all numbers on his excel sheet to determine the right price to buy a stock not realising that all the variables used in the analysis are subject to change without notice. These interconnected moving variables makes investing an art of approximation rather than a science of exactness.

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An investor should not get tied down to an intrinsic value number if the prospective payoff from an investment is large in context to the initial outlay. So if the intrinsic value of a stock is estimated to be ₹300 and the market price it trades at is ₹330 with a potential upside several times more than the current price it makes no difference whether the investor buys the stock at ₹300 or ₹330 but if the terminal value is ₹400 then returns can be maximised only by buying the stock cheap and hence an investor should wait for a price correction before buying.

In case of a secular theme, an investor can maximise return not as much by buying it cheap but by actually holding it till the entire length of the cycle. Here the purchase price is relevant but the holding period is equally significant. How many investors sell a stock after it doubles up only to see it double up again and then again?

Round numbers always hound an investor who by primary nature is fixated to these as reference points. For instance, more investors would like to buy a stock at or below 900 or sell it at or above 1000 but what if the stock drops to 901 before rising again or turns from 999 before reaching 1000?

A MISS COULD BE MORE COSTLY THAN A MISS-HIT:

The potential damage to the process of sticking to numbers in investing whether round or intrinsic can cause more harm than good. Theoretically, the damage to the upside is more than the damage to the downside. *A stock can fall only 100% so if an investor bought it 10% lower than what he had originally thought of buying it for he still stands to lose only 90% had he not bought initially and waited for this 10% downmove before buying.* However, the same stock can move up 100%; 200%; 500%;1000%; 10,000% or even more which proves that the damage to an individual's balance sheet in case of a miss is far higher than in case of a miss-hit!

A key question to ask is that why do most people lose money in stocks even if the odds of winning are so heavily loaded in favour of the buyer. The answer is that even if an investor's potential loss is 100% and his potential gain infinite, he loses because he caps his gains on stocks where he has been right

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by selling too early and holds on to his losing position till the very end as an amateur investor is more likely to sell a stock than to retain it after it has moved up 20% from his buy price. Similarly, most investors don't like selling a stock below purchase price irrespective of the quantum of loss which means that in spite of the odds of an unlimited gain against a 100% loss an average investor loses money because of the artificial tinkering that he does to change a favourable equation to an unfavourable one.

Many investors focus on bargaining for the last possible penny as the fear of loss from a potential drop in price is far more before an investor buys a stock, than it is after he has bought it and though it is important to protect capital, investing is not a game where one can be right from the word 'GO'. Most investors bargain for lower prices because they are paranoid of losing. *However, few realise that if the economic character of the business with respect to the current price was faulty than buying it 20% cheaper will still put 80% of their capital to risk.* In some cases, an investor should buy even if he feels that prices can go a little lower because while the terminal value of a stock is certain, lower prices remain uncertain.

The idea should be to look for great investing opportunities and not haggle a lot on the last penny and hence the fair value of a stock might be ignored in case of a company holding enormous future potential whereas for deep value bets it makes sense to focus on the estimated fair value so that the investor gets to maximise his gains. *This is because markets are not about cheap and expensive stocks but more about the cheap stocks becoming expensive and the expensive ones becoming cheap.*

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"The 'when' of all macro events is worth a million, the 'why' comes free of cost!"

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Chapter 10

WHAT MAKES FOR AN ECONOMIC BUBBLE?

A bull and bear market isn't exactly like life and death but it is very close to that!

The history of economic bubbles started from the introduction of paper money as the gold standard did not allow for the indefinite increase in supply of currency in circulation. Under the gold standard the intrinsic value of the currency used to run concurrently with its face value and hence most economies used to work at almost zero rates of inflation. Subsequently, the advent of paper currency and the development of the banking system helped create a situation where too much money could be used to chase too few goods. *This 'too much money' referred to as liquidity which when combined with leverage in a low interest rate environment helped create the bubble of economic fire on an asset or idea which was preferably new to mankind.* This 'new' starting from the tulip mania in the 17th century has been the origin of every bull market and is defined as something that was relatively unknown or unheard of before and could be an invention or an innovation of existing technology, modified for better commercial use.

LIQUIDITY, LEVERAGE AND THE NEW OF ALL THE PREVIOUS ECONOMIC BUBBLES:

The country where an economic bubble occurs will be at the cusp of an economic breakthrough, on way to becoming the 'new' financial superpower. Holland in the 1630's; UK in the 1850's; USA in the 1920's; Japan in the 1980's were all at the cusp of an economic breakthrough. Prior to the tulip mania Amsterdam had taken over as the leading economic centre of the world. When the U.S saw the big bull run of the 1920's leading up to the 1929

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depression the centre of world power was shifting from UK to the U.S as it later shifted towards Japan in the 1980's.

When India had a bull market between 2003 to 2008 investors were talking of India as the next superpower who would join China to capture world stage in the 21st century. At that time, the famous acronym 'BRIC' was coined to refer to Brazil, Russia, India and China but the 2003 to 2008 stock market rise was not restricted to India alone but was shared by several countries across the globe bringing to doubt the theory of India's rise as the new power of the 21st century.

The first economic bubble was the Tulip mania of Holland in the 17th century. The 'Tulips' being 'new' to the Dutch found demand from speculators who wanted to profit from a chain of increasing prices. The growth of Holland as an economic power fuelled the liquidity for this move as prices of 'tulips' rose more than sixty times in a matter of a few years before crashing back to where it started from.

The next big economic bubble was the South Sea Company where a company was formed with monopoly rights to trade 'slaves' in the far off areas of South America. The 'new' concept of trading in Latin America appealed to investors as they had seen the amount of prosperity generated by the shareholders of the East India Company.

In the 19th century, England was the most prosperous nation of the world. The invention of the Railways in the 1820's as a mode of transport was the 'new' thing that changed the entire economics of the UK economy.

The U.S railroad and canal bull market of the 1850's was based on the 'new' economic activity of connecting the entire American continent through a network of rail, road and canal links. Cheap money from Europe was used to fund these projects and at one point Europeans owned around a quarter of all U.S infrastructure assets.

The U.S bull market of the 1920's was formed on the basis of several 'new' objects of discovery. Radio, cars, televisions, refrigerators and aeroplanes were the 'new' things happening to the world. This period also saw the

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introduction of the 'new' theory of valuing stocks at net present value achieved after discounting their future cash flows which was rapidly replacing the earlier process of valuing stocks on trailing earnings and dividend yields.

In the 1980's, the Japanese economy with their large scale producing centres was becoming the 'new' leader of the world. The focus was shifting from U.S to Japan as the Nikkei rose almost eight times between 1979 and 1989.

The first big Indian bull market happened between 1990 to 1992 where the 'new' thing was decontrol of cement prices in 1989 and large scale liberalisation of the Indian economy in 1991. The Sensex moved from a low of 676 points on 28th February 1990 to 4,467 on 22nd April 1992 and then dropped back 55% by1993.

Post the 1992 bull run there was a lull for a few years and then a TMT (Technology, Media and Telecom) rally developed led by Nasdaq stocks. The handful of Indian software stocks started beginning their upmove from 1995 and the 'new' thing was software and the internet. Though the telecom rally in India started later in 2003 the 'new' cable TV service provider Zee TV rallied a few hundred times between 1993 and 2000. This rally peaked in 2000 when stocks like Infosys and Wipro went up in excess of a thousand times before dropping more than 80% each.

Meanwhile, a selective rally developed in PSU stocks starting from 1997, where PSU shares sold out of government offerings were the 'new' thing and stocks of defence equipment maker 'Bharat Electronics', oil service provider 'Engineers India', heavy equipment manufacturer 'Bharat Earth Movers Ltd', and government owned software company 'CMC' moved up between fifty to hundred times.

The next big rally in India happened between 2003 to 2008 when mobile telephony, retailing, real estate and infrastructure were the 'new' things that made our lives easier. Foreign investors poured in cheap money originating from the U.S Federal Reserve's easy monetary policy and a strong and sustained rally developed.

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The 2000 internet bubble of the NASDAQ, the 2003 to 2007, emerging markets bubble along with the the bull market of oil, gold and the U.S housing market were all a result of easy monetary policies of the Federal Reserve.

HOLDING A BULL MARKET STOCK FOR THE ENTIRE LENGTH OF THE BULL RUN:

Once the primary hypothesis of a new bull market has been identified an investor should check if there is a liquidity tap that is driving these assets up. The open ended dream funded by cheap liquidity will take the asset class up not by a few percentage points but several times over. *The asset class will hit a fresh all time high while cynics will look at the valuations and frown, analysts will try and justify the price rather than forecast it and the investor will himself feel an inherent sense of insecurity in the fear of losing it all but if he holds on he will do really well, enough to create a retirement fund out of a modest capital allocation.* Most investors will keep bailing out on the first signs of a downward move as the asset class in demand can drop 20% to 40% without notice. But an investor should buy the leading companies of the sector as stocks which move first in a sector move the longest and create the maximum amount of wealth whereas stocks that move after a while just mimic the leaders and fall at the first sign of trouble.

In the next chapter, we discuss the major economic bubbles that have happened over the last four hundred years of our economic history, the reasons for each of the bubbles their salient features, and the end of each of them. Understanding each of these bubbles is important for an investor as reading about these will help him in identifying and participating in the next bubble and also avoiding it after it has burst but as in all aspects of learning, these things are easier to write than to execute.

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BRIEF HISTORY OF ECONOMIC BUBBLES

Stock market tops and bottoms are created through the emotions of its participants and not by numbers on the balance sheet.

THE TULIP-BULB CRAZE:

When: 1637

Where: Holland

The Fall: Very difficult to quantify but at the peak, a person could exchange a single tulip for a piece of property while at the bottom the same tulip was worth only a few vegetables.

After its independence from Spain in 1593, Holland was fast emerging as a nation of economic prosperity led primarily by the technological advancement in the business of textile and ship building. At that time, the Dutch were introduced to tulips for the first time and as an economic boom always circumvents a nation where an economic *bubble is about to happen the tulip fever came to Holland just when it was at its prime. These tulips imported from Turkey were in great demand and traded at fancy prices. With time these flowers were affected by a viral infection, which generated shades of different colours on their petals. These colour patterns came in wide varieties and increased the uniqueness and rarity of the original flower leading to more demand and higher prices.

*Readers who are interested to know more about economic bubbles should read 'Devil Take the Hindmost: A History of Financial Speculation'. Authored by Edward Chancellor, this book provides a detailed account of the bubbles and is one of the best efforts at documenting economic bubbles.

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Meanwhile, the economic prosperity of Holland was creating wealthy citizens with fancy hobbies. A few of these were attracted to the world of speculation and as these tulips increased in price the owners started to stock up these flowers thereby depleting supplies. This decrease in supply on a perennially increasing demand widened the demand supply gap causing a steep and continuous rise in prices.

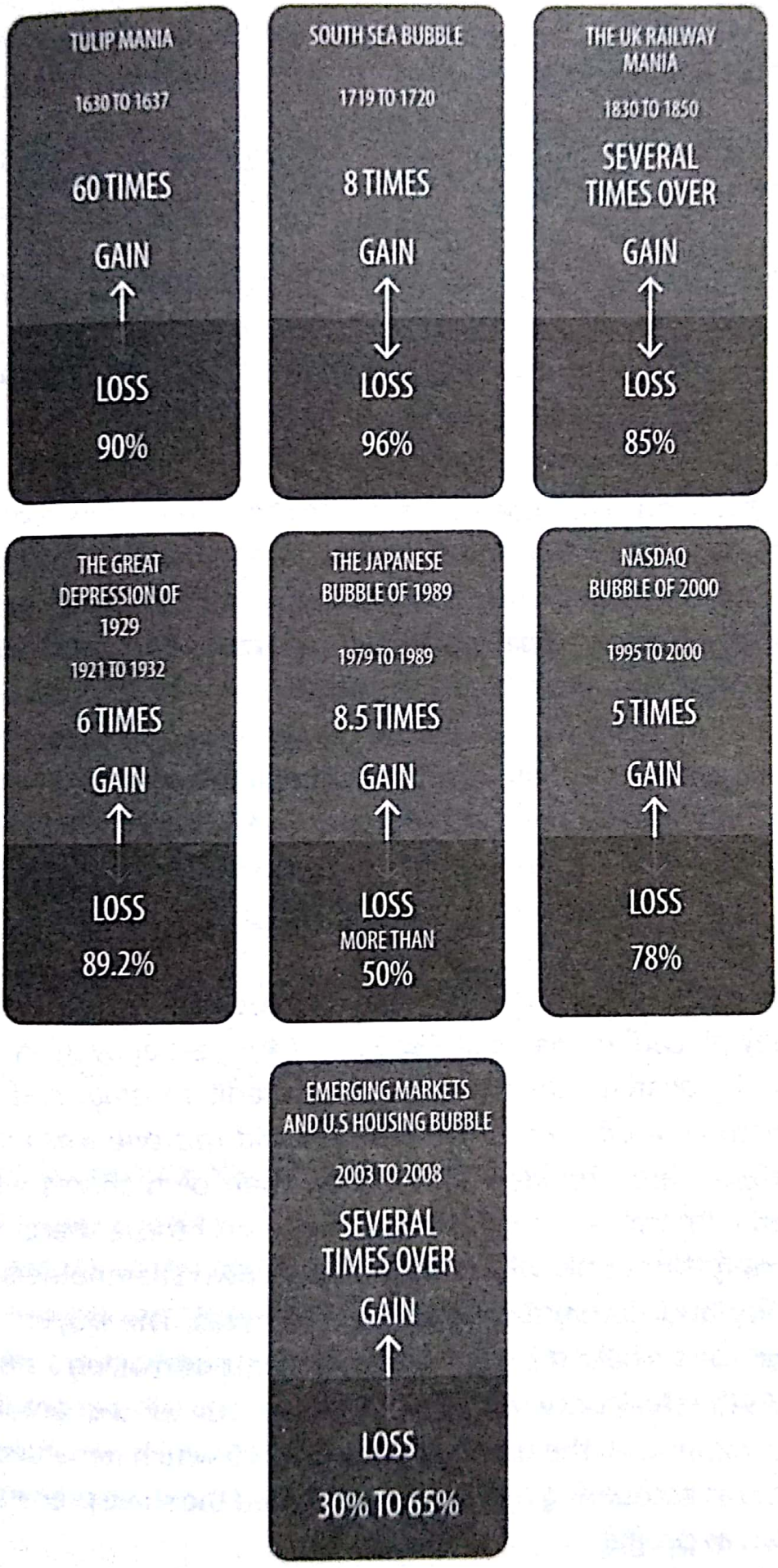
When an asset class experiences a rapid price rise it draws people to trade their cash, gold, land and anything else they can liquidate to buy more of the asset in demand. A similar thing happened to the Dutch as the entire country got into the business of buying and stocking tulip bulbs. An informal and loose futures market developed as sellers contracted to sell a certain type of tulip by style and weight to the buyer who promised to pay on delivery at a future date, leading to the first credit enabled boom in economic history. This gave rise to a sustained price increase and it is said that in the last leg of the run up tulip prices were doubling every few weeks.

As prices ran up, an auction in February 1637 was reported to be attended only by sellers, which signalled the suspicion that there were not many buyers left. Delivery was due in a couple of months and as this news got around the price of tulips dropped for the first time. The fall intensified as sellers outnumbered the buyers sending prices into a tailspin.

The falling price of tulips were now creating widespread repercussions. Many speculators had sold off their homes for a basket of flowers which was now worth nothing, sending the country into chaos and confusion. Amidst all this, the government attempted to capture the crash by offering to honour contracts at less than 5% of face value. The market plunged even lower making such a settlement impossible to honour. No one emerged unscathed from the crash. Even the people who had locked in their profit by getting out early suffered as their money was locked up in IOUs and promissory notes which were left unhonoured. The effects of the tulip craze left the Dutch very hesitant about speculative investments for a very long time.

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THE GAIN AND PAIN OF ECONOMIC BUBBLES



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THE SOUTH SEA BUBBLE:

When: 1720

Where: United Kingdom

The Fall: Stocks in the South Sea Company traded for £1,000 and when the company was finally liquidated its shareholders received £33 for each share.

Newton doubled his money in the South Sea Company. He made a profit of £7,000 and then the hype got to him again and he lost £20,000 by re-entering again at the peak. It was then that Newton said "I can calculate the motion of heavenly bodies but not the madness of people".

John Blunt having deep connections with the politicians took over the government debt of £7.5 million by compensating the debt holders through issue of shares of the 'South Sea Company'. In lieu of taking over the government debt the company got the profitable 'monopoly rights' to trade with the Spanish colonies of South America.

At that time, each stock of the South Sea Company traded for £128 and Blunt wanted to increase the price of the shares to £300 and beyond so that he would have to issue a lesser number of the over-valued shares and retain the profit by selling the balance shares in the general market.

Cashing in on the scarcity for ownership paper the South Sea Company successfully placed its shares at £300 and £400 respectively in April 1720 through an innovative scheme of shares on credit. *Leverage and credit form the cornerstone of all speculative bubbles and this one was no different.* Shareholders were provided funding on their own shares which were mortgaged with the company. The company kept these shares under lien thus reducing the supply while lending to its own shareholders increased the liquidity and demand for these very shares. The buyers were also encouraged to purchase the stock on installments by making a small upfront payment. As the stock price rose, the company made subsequent share issues at higher premiums to the nominal price of £100 which benefited the older shareholders as accounting regulations permitted the share premium amount to be shown as profits.

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On 15th June 1720, the South Sea company launched its third offer for sale of shares at a price of £1,000 even while the market price was only £750. This offer for sale allowed applicants to buy shares by paying only 10% of the money upfront and the balance in instalments. As the public queued up to buy shares, the overall economy was slowing down as businessmen found it more profitable to substitute work for speculation.

As the South Sea story got popular, new companies were floated to raise money which made the South Sea Company a hot stock in a hot sector. Sensing that the supply of shares from new companies would reduce the monopoly of the South Sea Company, Blunt filed writs against these new companies, which he claimed were operating against law and influenced the politicians to pass the 'Bubble Act' which restrained new companies from conducting any sort of business. Most of the shares at that time were traded on leverage and the decision to launch prosecution against some of these companies brought in a margin trigger leading to a collapse of the entire market. The shares of South Sea Company joined in the decline as traders sold off to make good the other losses and prices started to fall - almost vertically.

Seeing this precipitous fall, Blunt urged the Bank of England for financial assistance so that the shares could be supported at £400 but the Bank refused. By this time, John Blunt had already cashed out of his position. The fall was swift and deep and from a price of over £1,000 in July 1720 the stock dropped to less than £200 by September 1720.

Under public pressure, the government launched an investigation against John Blunt who first said that he did not remember anything but later testified that the object of the company was to make quick money by showing lucrative business opportunities. The company's treasurer disappeared and the directors who could be traced were forced to return back some money. The company was finally wound up with the shareholders receiving £33 per share.

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THE UK RAILWAY MANIA:

When: 1850

Where: England

The Fall: More than 85%

In 1767, England built its first canal linking the Manchester coal mines with the textile mills of Runcorn. Over the next few years, several hundred canals were put up bringing widespread benefits to the mineral and agriculture producers in terms of easy logistics with lower transportation costs. Buoyed by the success of these canal companies their share prices rose before the canal fever was suddenly terminated by the overall unrest created from the French revolution. While the initial canal companies were generating a return on capital of 50% the later ones formed to capitalize on the growing public frenzy could not muster up even a 5% return on capital.

A few years later, England was getting ready for the railway boom which was to substitute the other means of transport. In the mid 1830's, George Hudson, a man born to a family of limited means entered the railways business and spent his time in aggressively expanding operations by setting up a network connecting the various towns and cities of England. While his tariffs were high, Hudson compromised with the safety norms of the business to keep his costs low and used the cash generated from operations to rapidly expand his network by purchasing several competing railway links. In this process, Hudson had soon extended control to more than 30% of England's rail network lines.

The process of setting up a rail link was uncomplicated and simple as a few people had to get together to set up a company and carry out a survey on a link which they intended to connect. To raise capital, the company would offer shares to the public on a 10% down payment and get the proposed rail network approved by parliament. Setting up a railway company to raise capital became a fashionable venture and preceded any other economic activity. By January 1845, dozens of new railway companies were being set up to offer shares for subscription. In case of over subscription, the promoters released only a few shares to the public and kept a major chunk for themselves

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to create scarcity in the market, Prices were rigged up, forcing speculators who had short sold to buy at higher prices leading to more frenzied buying.

Neither the shareholders nor the promoters were interested in profiting from running a rail network. The object of the business was to speculate and profit from shares of companies where one could create ownership on a 10% down payment and the low interest rates facilitated leveraged speculation. Low interest rates with leverage which in this case was buying shares on a 10% down payment constitutes the backbone of any speculative bubble and both these ingredients were very much present both in case of the South Sea Company as well as the railway mania.

As the fever spread, railway lines were being set up in places which could not be justified by economic rationale and soon the proposed railway network exceeded twenty times the length of the country and four times that of the existing network. The total estimated cost of setting up this network was soon exceeding the total GDP of England at that time.

The frenzied speculation encouraged construction on several non-economical routes, a majority of which were not expected to make any money for their shareholders anytime soon. The existing railway structure had reduced the delivery lead time as a consequence of which businesses were keeping lower inventories leading to an overall improvement in efficiency. This increased efficiency temporarily reduced demand as companies adjusted to the realities of quicker supplies leading to a general slowdown in overall growth. Meanwhile, shareholders who had paid 10% of the capital were slowly asked to pay up the balance instalments while the defaulters were forced to sell off their existing position to save their shares from being forfeited.

By 1847, the Bank of England was raising rates as regular monthly calls from the railway companies was sucking off liquidity from the market, Trade was weak and the last jolt came from a higher than expected wheat harvest which sent wheat prices spiraling down. The overall depressed sentiment threatened to send the banks underwater and fearing a run down against its gold reserves, the Bank of England refused to lend against public securities. During this time, the rate of interest had risen from 2.5% in 1845 to 10% by October

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1847 which forced the government to intervene and urge the Bank of England to continue buying securities from the market. High interest rates acts like a dearth knell to any euphoria as it makes leverage costlier and also reduces the supply of money and even in this case the repeated raising of rates had a negative impact on prices as they started their long and continuous drift downwards.

At that time, it was also alleged that railway companies were paying dividend out of capital and were not making all the money that they were reported to be making. Amidst all this, as the rail network grew, the average tariff saw a decline even while volumes continued to expand. The average revenue per mile in 1848 had dropped by 30% to £2,500 from the figure that was being reported a few years back. By 1849, Hudson had to cut dividend and his stock took an immediate plunge. A committee was set up and it was observed that Hudson had indeed paid money out of capital and as the allegations grew, several of Hudson's private dealings with the publicly listed companies were brought to the fore. He was also reported to have engaged in rampant insider trading and as a personal guarantor to the borrowings of his listed companies Hudson was charged for recovery and arrested. The father of the railway mania later died in 1865 leaving a total of two hundred pounds.

Meanwhile, the railway shares had declined by around 85%. The total loss in market value of railway stocks at about £230 million equaled almost half the GDP of England at that time. Burdened by a huge network of unwarranted and uneconomical railway routes the average tariff per mile took a plunge resulting in lower profits and increased bankruptcies. However, the development of this network in the 1840's had created a huge economic boost in terms of economic development. The frenzy in railways had resulted in connecting the entire country – at a cost.

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THE GREAT DEPRESSION 1929:

When: 1929

Where: USA

The Fall: 89.2% from the peak of 1929.

The investing community remembers the crash of 1929 when the Dow Jones Industrial Average fell 89.2% between 1929 and 1932. However, very few recall that prior to this fall the Dow had rallied almost six times from its low of 63.9 points in August 24, 1921 to the peak of 381.7 points that it hit in 1929. *This rally in the Dow was a result of a spate of 'new' technological breakthroughs leading to the invention of the telephone, radio, car, television, refrigerator, motion pictures and the aeroplane.*

The early part of the 20th century was the period of 'new' inventions as the entire world was seeing a significant change. The first world war had ended and America was seeing sustained economic activity with growing international trade and moderate inflation. The 'new' products were quickly replacing the old and a general sense of prosperity could be seen all around.

There was a feeling that the current spate of economic expansion would extend endlessly into the future. America was prospering and one of the important aspects of a bull market is to make the market participants believe in the theory of permanent increase of wealth and well being. The participants were also convinced that the Federal Reserve could solve the issues of business cycles through its open market operations (buying and selling government bonds) and by influencing interest rates.

The injection of easy money made a great case for rising corporate and consumer debt, as Americans were buying stocks of leveraged listed companies with borrowed money. The avenues of consumption instigated by discovery of 'new' products and innovation of existing ones encouraged people to borrow and spend more than their income as the citizens were trading a part of their future economic effort for present consumption (buying on instalment credit).

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Amidst the euphoria, the price of stocks of leading companies rose much ahead of the rise in profits. It is reported that shares of General Motors rose more than 150 times in the ten years preceding the 1929 crash while revenues for Radio, a company selling radio sets and also a broadcaster grew at 55% CAGR or 14 times from 1922 to 1928 while the company's stock price rose at an annualised rate of 72% or 76 times for the period 1921 to 1929. At the peak, the company traded at a little less than twenty times its book value and had a P/E ratio of 73 times even as it did not declare any dividends.

The challenge to valuing companies that did not declare dividends also saw the introduction of the theory of valuing stocks at net present value, achieved after discounting their future cash flows. This 'new' method was fast replacing the earlier process of valuing stocks on trailing earnings and dividend yields. This transition was necessary because stock prices had moved far beyond what could be justified under the old method of evaluation and it was felt that the old theory of valuing a stock on the basis of trailing earnings and dividend yield had become redundant.

Multi layered leveraged holding companies, having subsidiaries in the utility business were another set of stocks that were in great demand. Meanwhile, there was a rise of investment trusts or quasi mutual funds which held shares of different companies as they provided adequate diversification to the small investor with limited capital. These investment trusts leveraged their shares and bought more thus forming an inverted pyramid which was ready for collapse, on the first signs of disequilibrium.

By the summer of 1929, the bull market was on roller skates with stock prices advancing on a daily basis. In September 1929, the British businessman Clarence Hatry was detected for fraud just as he was about to merge his various iron and steel companies to create a $40 million entity. As the news of this debacle flowed, the Bank of England raised rates pushing British investors to withdraw from U.S markets. By the first week of October 1929, General Motors was experiencing a fall in car sales and the markets started to slip lower.

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It started drifting lower till Monday the 28th day of October, 1929 when the markets fell around 15%. The next day saw accelerated panic, traders and investors had lost their composure, enquiries and orders had clogged the telephone lines as all avenues of communication broke. The entire market fell on its own weight with leading bull market stocks like Radio collapsing more than 50% in two days and down nearly 75% from the all time high. Shares of banks, utilities, investment trusts and entertainment companies were also down by more than half - in almost no time.

As the markets collapsed and the foreigners withdrew, even the rate cutting by the Federal Reserve did not help. However, the markets after a brief rally in 1930 went into a long secular decline. Meanwhile, the government directed the industry not to lower wages which in the backdrop of falling asset and commodity prices reduced the economies of production while increasing unemployment.

Over the next three years unemployment in the U.S rose six times whereas industrial production fell 46%; wholesale prices were down 32% while foreign trade impacted by tariffs and controls collapsed 70%. The catastrophe was complete when the Dow finally bottomed out at 41.22 points on July 08, 1932, a 89.2% drop from the high of 381.7 points it hit on September 03,1929.

THE NIKKEI BUBBLE:

When: 1989

Where: Japan

The Fall: The Nikkei which had peaked in at 38,915 points in 1989 fell 48% by 1990.

Japan continued to show rapid growth post the second world war. This growth was assisted by the construction of the properties damaged during the war and the development of the new ones. The economy also benefitted as a leading supplier of goods to the Korean war of the 1950's. Meanwhile, the U.S in its post war occupation from 1945 to 1952 had extended financial assistance to the extent of $1.9 billion (4% of Japan's GNP) to the island nation to undertake land and other reforms. These initiatives were expected to

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increase growth and facilitate talent development among the local population on a broad scale.

Aided by these factors, the Japanese economy expanded rapidly while generating a growth of around 10%. The Olympics in 1964 continued to support the development process as the nation set up the Bullet train service and modernised its ports and roads while spending heavily on skill development and training of human capital.

The government continued its drive towards capital intensive industries and the 1970's saw a growth rate of close to 8% with the overall economy moving into trade surplus. In 1980, the nominal per capital income of Japan was 105% of the U.S, up from a mere 10% in 1955.

By this time, Japan's increasing domination in world trade had started to impact the American industries. The Yen continued to appreciate from its level of 360 to a U.S Dollar in 1965 but the real push to the valuation of the Yen came after the Plaza accord in 1985 when leading economies got together to declare that the U.S Dollar was overvalued. This put the Yen on roller skates as it moved from around 239 to a dollar in 1985 to 128 over the next three years.

Right from the 1960's the Japanese economy with their large scale producing centres was becoming the 'new' leader of the world. The strong Yen made imported goods cheaper and as oil prices were on a falling spree the easy monetary policy of the Japanese central bank created a huge land and stock price inflation while Japanese companies like Toyota, Mitsubishi, Matushita, Sony and Sharp took over market share from their western leaders.

The Japanese government continued to channel low cost funds from its domestic pool of savers to the debt heavy, low RoCE, manufacturing industries. Imports were discouraged and exports were incentivised as the country focused on expanding output in a bid to capture global market share.

Meanwhile, Japanese corporations continued to prosper and invest in the U.S, it is reported that the Chairman of Mitsui Corporation bought the Exxon building in Manhattan for $610 million by overpaying $235 million just

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because he wanted to see his name in the Guinness Book of Records. The Japanese were wanting to create impact - at any cost.

In the early 1980's, the government exempted local companies from paying capital gains tax on their stock investments which encouraged the corporations to flood the stock market with money. This coupled with a more than four times increase in money circulation from 1985 to 1989 led to a massive increase in speculative activities. Rising share prices resulted in more profits and more stock price gains as Japanese corporations saw speculative profits increase more than three times by 1987.

In the frenzy of this bull market, issue of new paper could not have been left far behind as the government initiated disinvestment of its holding in Nippon Telephone and Telegraph (NTT) in October 1986. Against an offer for 200,000 shares the company actually received an application of several times the auction quantity, even before the government actually disclosed its offer price. The demand supply mismatch was so adverse that ultimately these shares had to be disposed off by a lottery system. On 2nd February 1987, NTT got listed at Yen 1.2 Million and moved up 25% over the next two days as the bull market was entering its most frenzied moments. Later that month, a G-7 meeting was called where finance ministers from these seven countries met to halt the rise of the Yen against the U.S Dollar by cutting interest rates.

The lowering of interest rates put the bull market on fifth gear and it is reported that NTT which had listed at Yen 1.2 million on February 02, 1987 moved to Yen 3.2 million in a few weeks. The market was valuing the company at a multiple of 200 times earnings and the market capitalisation of $376 billion was at that time exceeding the market value of all stocks listed in Germany and Hong Kong. The rise in price was also backed by the popular belief that money cannot be lost in a government company.

As stock prices rocketed, the Recruit Cosmos scandal surfaced linking two former Prime Ministers, civil servants, bureaucrats, industrialists and journalists as being deeply involved in the stock market. The illegal payoffs were established as the nation continued to reel under a severe threat of an economic disaster. *A scandal marks the last stage of any bull market and this one seemed to just follow suit.*

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The stock market frenzy on the other hand was nearing its peak. All throughout the 1980's Japanese stock prices rose three times faster than earnings resulting in a massive P/E expansion. A significant part of the earnings were also a result of profits from stock market operations of these companies leading to questions on the sustainability of these numbers. The P/E ratio reached 80 times with dividend yields at less than 0.5% as the Nikkei moved to 38,915 in 1989. The large flow of credit and liquidity also inflated the property market which at the peak was worth Yen 2000 trillion or more than four times the value of all the property in United States and the grounds of the Imperial Palace at Tokyo was stated to have exceeded the worth of California in terms of value.

Large corporations like NTT, Tokyo Electric power and Nippon Airways were now being valued in terms of their land banks. Nippon Airways was now valued at 1200 times earnings. Most of the large corporations were tied in a complicated set of cross holdings encouraging companies to save large stretches of land bank for purposes of capital gains. Amidst all this, Japanese investors were also seen buying art, diamonds and other assets from the international market.

While brokerages were predicting the extension of the bull run for the next several years the Nikkei started feeling the pain of speculation when interest rates were raised for the second time in December 1989. As the era came to a close on raising of interest rates, prices of all asset classes started cracking. The Nikkei which went from 4,867 on January 01,1978 to 38,915 on December 29,1989 dropped almost 48% by September 1990 and is still struggling to come anywhere close to its old highs. By 1995, several banks, and finance companies were under strain forcing the government to come forward for a bailout. Growth had slipped and the economy was on the tenterhooks of a long and sustained recession. Interest rates were cut to near zero as Japan still continues to pay the price of its economic excesses made twenty five years ago leaving the Nikkei still more than 50% below peak levels.

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THE DOT-COM CRASH:

When: March 2000

Where: Across the globe where ever technology and particularly Internet stocks were traded

The Fall: The Nasdaq Composite moved 7 times from 1995 to the year 2000 before falling 80% by 2002.

The internet was initially created by the U.S military for its internal use a long time before its access was opened for commercialisation to the general public. The mid 1990's saw the massive expansion of the World Wide Web as companies were being incubated to launch various internet related services to profit from this rapidly developing industry. As the overall environment of growth was expected to continue for several years it attracted young entrepreneurs who were eager to float new businesses from this seemingly never ending stream of prosperity. Particularly interesting was a company called Sycamore Networks formed by the the brother-in-law of Narayana Murthy, the founder of Infosys. *The company was named after the 'Sycamore' tree whose life expectancy is assumed to be four hundred years old. Sycamore, however could not manage to stay for even fourteen years as its market cap evaporated from $40 billion at the peak of the tech bubble to $66 million a few years later when it was delisted from the Nasdaq.*

During that time, Internet start-ups were mushrooming from garages and living rooms *as money was backing ideas for a share of action rather than for a share of profits.* While most of the newly floated internet ventures generated viewerships or website hits with eye balls they lacked a strong revenue generating capability. Investors were therefore betting on the premise that if you can have eye balls and website hits, you will have revenue to back it up some day - but 'when' was the question.

As the momentum grew, technology and internet related companies were being valued ahead of the established players. Internet companies like AOL traded at a P/E of several hundred times their earnings while IBM traded at a P/E of around 30 times only.

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Of course, the bulls were cheering with just one slogan "Its different this time" as they did in all the previous mega bull runs.

At that time, the entire market was dichotomised between stocks of the new and the old economy as sectors such as Technology, Media and Telecom (TMT) constituted the new economy whereas the old traditional brick and mortar companies made up the old economy stocks. The idea for many of these new economy companies was to create a network of people by offering free services and then hope to do something later on to monetise this network. The first part of the strategy was clear and needed lots of upfront spending, whereas for most companies the second part was still in the formulation stage. In spite of this, the abundance of cheap liquidity was encouraging the financiers to back these new untested ventures to check if these business plans made any sense in the real world as they did on paper.

As the IPO's of Internet companies emerged with amazing frequency it swept the entire spectrum of global investors into euphoria over the seemingly superior prospects of these businesses. These companies could not be evaluated on the basis of the P/E ratio because a majority of these businesses had no earnings and the discounted cash flow statement could not be made because even the promoters were unsure about how their future cash flows would look like. As the market cap for some of these companies were bid up to several hundred times their sales, a new tool for evaluating internet companies was identified which was to evaluate companies on the basis of eyeballs and website hits.

Towards the peak of the dot com bubble, the stock price of these internet companies seemed to defy all gravity as the Nasdaq hit its peak of 5,132 points on March 10, 2000. At that point, the total market cap of the U.S internet companies had ballooned to $1.3 trillion or around 8% of the entire U.S. stock market capitalisation. The stretch in valuation was complete and ready for a burst - anytime.

Over the next one month the Nasdaq index was down 20% as it started its downward drift, market participants and analysts attributed it to a normal correction in a bull market whereas in reality it was a collapse waiting to

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happen and when news of the court order declaring Microsoft as a monopoly was released on April 03, 2000 the Nasdaq slumped 15% the following day from 4,283 points to hit 3,649 points thus signalling the end of the bull market.

Over the next 18 months, till the destruction of the twin towers the U.S markets had collectively lost 35% of the market value. The effect of this loss was colossal and far reaching. Pensioners and retires who had bet their savings on listed internet companies were forced to look for new jobs to make up for their stock market losses. *When the bull market ends, the stocks of the sector leading the bull charge falls like a loaded truck going downhill without brakes and there were many such trucks rolling downhill without brakes at that time, taking with them the investors as well.*

Leading the fall were the internet companies without earnings. As companies reported losses a few folded outright within a few months of their offering. In 1999, the U.S market saw 457 IPO's, most of which were internet and technology related, out of which 117 doubled in price on the first day of trading. In sharp contrast, the year 2001 saw a meagre 76 IPO's with none of them doubling on the first day of trading.

Some companies were making losses to the extent of twenty times their sales. Freeinternet.com was one such company that provided internet access to over 3 million Americans and had made losses of $19 million in 1999, against a revenue of $1 million. Worldcom the long distance telecom carrier went bankrupt as it was caught and tried for accounting fraud while Nortel Networks folded up a decade later and Lucent Technologies, a spin off from AT&T ran into trouble and was acquired by Alcatel in 2006.

The biggest benefit of the dot com bubble was the expansion of the computer and the internet whose penetration and global acceptance increased the productivity of all the sectors. It is estimated that the computer and the internet increased the productivity of not just U.S businesses but that of economies across geographies, the benefits of which were expected to continue for a long time to come.

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THE U.S HOUSING BUBBLE & THE EMERGING MARKETS COLLAPSE:

When: October 2008

Where: Across the globe especially the emerging market nations

The Fall: The Dow Jones Composite fell 55% after hitting a high of 14,164 points on October 09, 2007 while many emerging markets fell 60% to 70% and the loss to the general portfolio was above 80%. Our own Sensex which rose from 2,828 in 2002 to 21,206 in January 2008, fell 62% by March 2009.

Post the dot com bubble and the 9/11 attack on the twin towers the U.S economy plunged into a deep recession. The deteriorating state of the economy compelled the Federal Reserve to an aggressive rate cutting spree which saw interest rates drop from 6.5% in 2000 to 1% by 2003. This cut in interest rate flooded the global economy with cheap doses of liquidity which found its way into commodities like crude oil, metals (including gold and silver) and more importantly stocks of emerging market nations.

In 2003, Goldman Sachs released a report stating that the 'BRIC' nations would be the new leaders of the global economy making the stock market of these emerging nations the new investment theme for global investors. It was estimated that China would surpass the U.S to become the world's largest economy by 2050 while India would take the third position. Added to this thought, was the growing insecurity of the U.S going into a deep depression in the backdrop of growing debt and falling growth.

The setting was perfect. There was a reason for being bullish and there were a lot of dollars to be put on the table. While emerging market stocks moved up on one side, the U.S housing market kept stretching itself on the other as banks and lending institutions were aggressively advancing low quality mortgage loans without adequate risk controls. The U.S housing market had seen years of advancing prices and the low interest rates encouraged the home mortgage business, as buying homes was becoming less of a necessity and more of an activity to profit from rising property prices.

As the Fed continued with its cheap money policies the lenders went down the quality front as from initially looking for proof of income with verified assets the

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lenders started asking for verified assets with self declared income only. This was further relaxed to no income but just verified assets and finally loans were being made on the basis of credit scores to people with "no income, no jobs and no assets" or NINJA loans. Sub-prime lending or inferior quality loans was becoming popular as is evident from an increase of its share in the total mortgage business from 7.4% in 2002 to 23.5% by 2006

The unprecedented leveraging cycle led to a steep rise in household debt which had increased to 127% of disposable income by 2007. *Rising home and asset prices was creating a wealth effect, as people were being encouraged to borrow more and save less.*

While credit was expanding, investment bankers and financial engineers were getting along to break these mortgages under various derivative products and then create a market for second and third level derivatives of these instruments.

Meanwhile, as the housing boom entered a phase of acceleration and threats of an immediate recession receded the Federal Reserve increased interest rates by raising it 17 times to take it up from 1% in 2004 to 5.5% by 2006.

The hike in interest rates had a negative impact on home prices as most of the mortgage was on floating rates which reduced the debt service capacity of the marginal borrower, By 2006, home prices started to top out after a stupendous multi year run as the U.S was entering a state of economic instability. Falling home prices started a chain of defaults as lower prices compelled lenders to ask for further funding and in case the borrowers were unable to put in more cash, the banks were forced to effect foreclosure which aggravated the selling to send down home prices even lower.

Fannie Mae, the largest mortgage underwriter in the U.S which had been forced by the previous administrations to advance loans to the low and middle income borrowers was now under pressure to maintain its high growth trajectory. As the mortgage crisis expanded, Fannie Mae continued to make loans to the subprime borrowers which ultimately ended in pushing the over $50 billion market cap mortgage lender to the brink of bankruptcy.

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The crisis slowly snowballed into a catastrophe and as the underlying asset was falling in price these mortgage backed securities were losing value quite rapidly. This discouraged both local and global investors to look upon these instruments as potential investments and by mid 2008 America was standing on the verge of an economic collapse, unprecedented since the great depression of 1929.

The failure of Bear Sterns in the beginning of 2008 was brushed aside but when Lehman Brothers collapsed on September 15, 2008 the financial system was brought to the edge of bankruptcy. By 2009, the U.S had lost nine million jobs, which was around 6% of the labour population. As the fall in home prices accentuated to 30% from peak levels the effect was wide and far reaching.

The credit rating agencies were also guilty of oversight and negligence as they continued to rate the errant companies for the highest ratings even a day before these companies were to go bankrupt. Investors were now faced with the peculiar question of whom to trust and whom not to?

The crisis was global as European banks also continued to struggle with their own economic crisis. Emerging market nations also felt the pinch as foreigners sold off to meet redemption pressures back home.

Contrary to 1929, the Fed in 2008 opened its purse strings and was pushing liquidity into the market by taking over the toxic bonds on its own balance sheet and infused the market with a heavy dose of liquidity that extended to over a trillion dollars. *The dollar being a currency of global acceptance was helping the U.S to stay afloat as the Fed infused liquidity into the system to get out of the problem. Had this been a Thailand or a Taiwan the currency would have depreciated 60% putting the economy on a concrete path of financial breakdown. The dollar also ran the risk of losing its value but with the Euro zone also in trouble the question was that even if the dollar was to depreciate what would it depreciate against?*

The answer was that paper currency was by itself a faulty tool of measurement but having gone too far, the world could not have moved back to the gold standard, so all paper currencies depreciated against a basket of commodities like gold, silver, crude oil and metals - both ferrous and non-ferrous. After all the dollar had to lose value and it did.

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Chapter 12

IDENTIFYING TOPS AND BOTTOMS

In most cases, cash does not get converted into stocks at market bottoms just as stocks don't get converted into cash at the tops.

There are no foolproof methods of catching the stock market tops and bottoms. as identifying these turning points is as much a matter of skill as it is an event of chance. *The reason why these tops and bottoms remain elusive to the investor as well as the forecaster is because they are formed as much by the fundamentals of the business situation as they are by the emotions of the participants.* Moreover, forecasting the emotional swings of the crowd is a matter of subjective reasoning rather than a theory of objective analysis. However, in order to create wealth out of investing it is not necessary for an investor to buy at the bear market bottom nor is it essential for him to sell at the bull market top as participating even for a majority of the uptrend and staying away from the major part of the subsequent downtrend is good enough for making outsized investment gains.

PRICES ARE NOT JUST VALUATION:

The stock market is not just about making profitable investment opportunities it is also about maximising them. *Irrespective of valuations, there are times in the market where a seller of securities has to abstain from selling because he feels that prices will rise further and there are times when a buyer has to refrain from buying because he fears that prices will plummet even lower.* There is nothing wrong in this strategy as ultimately markets are about making money rather than about buying stocks at precisely the right valuations. It is with this thought that each investor should have some working knowledge on how tops and bottoms are made though pinpointing them remains an elusive art.

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The concept of fair value which an investor expects to transact at suffers from two drawbacks a) the assumptions made in computing the fair value are themselves a bunch of moving numbers and hence the fair value thus derived is subject to a rapid and sudden change and b) the price of a stock reflects both the fundamental as well as the perception (emotions) of market participants. So while it is easy to compute the intrinsic value based out of financial numbers it is difficult to put an economic number to the sentiment of market players which changes on a tick to tick basis. Both of these collectively ensures that price stays separated from value - most of the time.

THE RISE IS MORE POWERFUL THAN THE FALL:

Past study of theme based bull runs reflected certain reverberating patterns which indicates that though the rise is stupendous especially before the end, the fall is painful but not so much as it is made out to be. Most participants feel the pain at an exaggerated level because they initiate participation in the fall after the story has ended and not when the story is in full swing. One reason for this could be that it is easier to buy a stock making new lows than it is to buy them while they are on way of making new highs.

On the way up, bull market stocks move up twenty, fifty and in some cases more than hundred times. However, on the way down the high quality leader falls 50% to 60% whereas the low quality stocks may drop 80% to 95% and in some cases even up to 100%. *Despite the fall, investors who enter the stock even a year before the end of the trend remain adequately compensated while the ones who get trapped are the late entrants who start buying after the stock has made its top and is on way to ground zero.*

INVESTORS BUY ON THE WAY DOWN THAN ON THE WAY UP:

Having bought a stock with the recency effect of assuming the immediate past winners to keep repeating themselves, an investor tries buying the past bull market stocks on every decline, not realising that *stocks ought to be, bought when they are going up on improving fundamentals rather than when they are coming down on a deteriorating perception.*

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More investors bought Infosys after the stock hit its peak of ₹1,726 on March 08, 2000 than they did before it. The establishment of a past high price provides a strong anchoring bias for the investor to get sucked in. This coupled with the pain of having missed the flight on the way up compels them to get in on the way down.

Similarly, more people bought Unitech, Larsen & Toubro and BHEL after they made their long term peaks in 2008 and started on a secular downmove than they did before it during 2003 to 2008, when these stocks were on the way up.

WATCH IF THE HIGHS ARE SUSTAINING OR NOT:

In case of a stock that keeps making new all time highs, the investor has to sit back and watch whether these highs are sustaining or not and in that endeavour he would have to pay full attention to the price behaviour. *The stock which is making new all time highs will be expensive on P/E basis but If the majority thinks that a stock or a sector is expensive it probably isn't the time to sell yet. Here the most vociferous protestors about stock overvaluation are generally the investors who are not a part of the party.* If a stock is making new highs and has gone into extended valuation and stays within 7% of this new high for the next 5 to 7 trading days then that high isn't a terminal top. In other words, a stock that has been a leader of the bull market starting from ₹30 now hits a price of ₹2,000 and does not fall below ₹1,860 for the next few days from the time it first hit ₹2,000 will not be considered to have made a top at ₹2,000. The top will be formed where the overwhelming number of sellers will push the price down immediately within a few hours of the stock hitting ₹2,000 and the stock will show a deep intraday fall from the highest price of the day.

This fall will continue and extend to more than 10% from the highest point of that day and within the next couple of days the slide will accelerate to go down further. If a stock does not show an immediate accelerated fall the bull market will generally be considered to be intact. The logic is that for a price to become the top, the number of sellers have to be significantly larger than the number of buyers and the selling should be so large that it should not let the price remain anywhere nearer to the all time high. Consequently the fall has to be sharp, swift and accentuated before becoming secular.

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LIQUIDITY OUTFLOWS CREATE TOPS:

One of the clear signals of aggravating bullishness is the launch of fresh mutual fund schemes to raise money to buy stocks of the sector in demand. So whether it was the Unit Trust of India's Mastergain in 1992 or the several dozen technology mutual funds in 2000 or the infrastructure and power related funds of 2008 the bull market never ends unless there is a deluge of fresh IPOs and sector specific mutual funds. *After all, extended valuation by itself is not enough to put the market into disequilibrium. The primary catalyst for creating the disequilibrium is any mechanism that can suck the liquidity out of the system.* This may happen either through IPOs or new fund offerings or hike in interest rates or in many cases all of these, working together.

Most emerging markets are controlled and dominated by foreign money which causes these foreigners to reduce the speed of liquidity inflows on any negative event in their home country. This is exactly what happened in 2008 when the deteriorating U.S economy forced investors to withdraw from emerging nations leading to a rise in the value of the dollar and a fall in the stocks of the emerging nations from where the foreigners were pulling out their investments.

As a bull market stock rises in price and reaches its high it encourages the participants to get on maximum leverage. This phenomenon of market players being on maximum leverage creates a very unstable market structure where a minimum drawdown causes maximum damage by pushing the entire market into a state of disequilibrium. This situation also arises because companies discount the best possible events for the future even while valuations are extended.

A bull market tops out when there are very few new market players left to be buying a stock while most of the old ones remain on tenterhooks with minimum long term conviction. The increased confidence for the short term trader puts them on maximum leverage which makes the entire market system vulnerable to either a small liquidity outflow or a even a reduced inflow of fresh capital.

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When prices drop a little, they fall a bit more as it puts the leveraged players under margin calls which initiates a chain reaction as further drop in prices results in deleveraging of existing participants who sell shares that they had bought on finance and which they had no intention of holding for long. A confluence of these factors maximises the panic level bringing down stock prices like a cascading waterfall.

Though I don't recommend buying shares on margin it makes sense not to fund a margin account in times of a margin call and to let the financier sell the stock on the first sign of trouble. In normal cases, an investor throws out a lot of good money after bad, by trying to keep up to the margin calls.

ACTUAL FUNDAMENTALS ARE DIFFERENT FROM FORECASTED ONES:

An investor who is keen on making money, buying stocks of companies which he thinks are priced at less than what they are worth, should look at falling prices with a curiously open mind as no one likes to see a stock trading at a lower tick from the price that he bought it at. *Even though the essence of investing is not to think of the next possible trade that one unrelated market participant executes with another it makes sense not to be buying stocks even when they are falling a great deal below an assumed fair value, if these stocks were the leaders of the immediately concluded bull run.* This is because many times the profitability expectations of the market on a stock is erroneous putting the computation of fair value itself under severe doubt and suspicion.

In an era of rising prices the actual results of a company are better than expectations whereas in an era of declining prices the actual results of a company are worse off than what the market anticipates it to be, making the fair value computation, an exercise that serves little and hurts more at least during the turning points.

EMOTIONAL CONTENT OF A STOCK MAKES A TOP:

As argued above, identifying a top before it is actually made is a futile exercise. This does not mean that investors should not provide long range targets. *The targets that investors set for themselves are formed out of the fundamental attributes of a business which remains simple to estimate on a broad scale but*

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difficult to forecast to precise numbers. However, as tops and bottoms are not made by the fundamental attributes of a business but with the emotions of the participants, an investor may find it extremely challenging to set precise turning points because while there are methods of capturing the intrinsic value of a stock there are no ways to estimating the emotions of the crowd whose significance in price discovery is maximum at these turning points - maybe as high as 60%.

Many investors would argue on the sanctity of this "60%" number but putting this number is just an effort to magnify the spirit of the argument and not an attempt to create a foolproof water tight classification between valuations and emotion. The logic behind assigning this number is to suggest that at these turning points more than half of the stock price is built by emotions while valuations form only 40% of the price.

It is interesting to share as to how we can attribute 60% of the price behaviour to emotion. It is generally seen that leading bull market stocks correct 60% in the next one year of having reached the top. Most of these stocks also undergo a price increase of one and a half to two times in three to six months before reaching the top. So if a ₹4,000 stock reaches ₹10,000 at its peak and in three months of the bubble being burst comes back to ₹4,000 this incremental ₹6,000 or 60% of the peak price movement can be attributed to the emotional content of a stock.

LAST LEG UP TO THE TOP:

One of the critical aspects to understand in this argument is that these signals deal only with long term tops. Intermediate tops could occur anytime and are not easy to decipher. The main criteria of a top can thus be summarised as under:

- An already expensive stock leading the bull market showing no signs of correcting makes a big dash into its bull market peak moving 60% to 100% in three months, going from an outrageously expensive to a thoroughly bizarre valuation.

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- None of the fundamental analysts could justify the price three months before the final dash and certainly not at the peak as the stock defies all logic and reason while making new lifetime highs.

- Prices fail to hold at the top by more than a few hours. In most cases the top is made on intraday prices where the stock sees a sharp correction towards the close after having fallen vertically from its intra day high.

- Prices keep falling precipitously from the next day; valuations are still expensive thus causing an irreparable damage in the following three months. However, the prices three months post the peak would not seem that ugly when compared to prices three months before the peak. In other words, a steep rise is followed by a steep fall.

The following example with respect to our past bull markets suggest the presence of this "last leg up to the top syndrome":

THE STORY - THREE MONTHS BEFORE AND THREE MONTHS AFTER A BULL MARKET TOP				
		3 months before the peak	At the peak	3 months after the peak
Sensex	1992 Bull market	2007	4546	2972
ACC (₹)	1992 Bull market	130	399	182
Nasdaq Composite	Tech bubble – 2000	3636	5132	3893
Infosys (₹)	Tech bubble - 2000	625	1726	999
Unitech (₹)	2007 Bull run	321	546	293

As a participant in any of these markets, all that an investor had to do was watch the price behaviour of the leading bull market stock. *A dramatic rise of an already extended overvalued stock three months before the peak followed by a dramatic fall of the stock to an almost equivalent level of the price three months preceding the peak, signals a strong end to the long term bull market.*

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One of the classic attributes of tops and bottoms is that a top will be formed even as the company will be declaring very good profits and growing at above average rates of growth while on the same logic, a bottom will be formed even while the company will be posting dismal results and many times fighting for its very existence.

BOTTOM FORMATIONS:

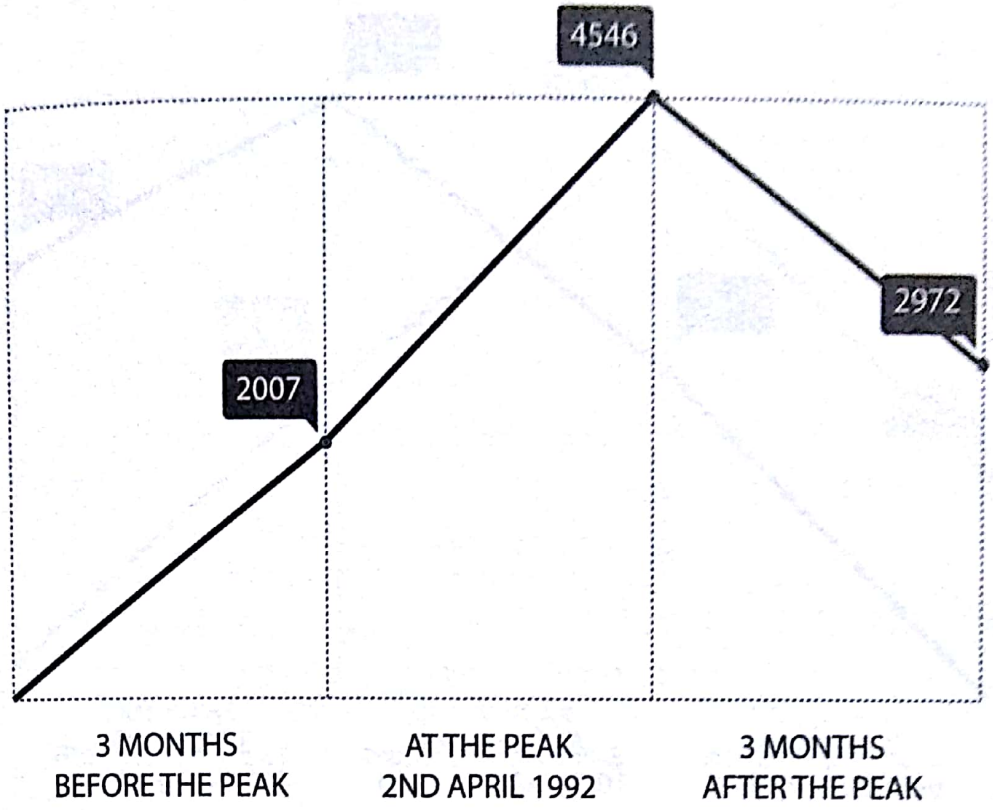
Bottom formations are totally different in the character and nature of price movement from that of the top. Unlike the formation of tops where the price moves in swift strokes and then hits a peak to retrace back sharply within a day or two, a bottom formation is relatively slow as prices consolidate at a point for days, weeks and even months before making an upmove. That is why an investor gets enough time to buy at the bottom while he gets almost no time to sell at the top.

The price pattern at the bottoms will be long, hard and rounded. As prices fall, the level of disequilibrium reduces with each percentage drop in price till it reaches a point where equilibrium gets re-established. By this time, sellers get exhausted out and volumes become dry as the interest, confidence and perception of the participants are at its minimum while the degree of pessimism remains the highest.

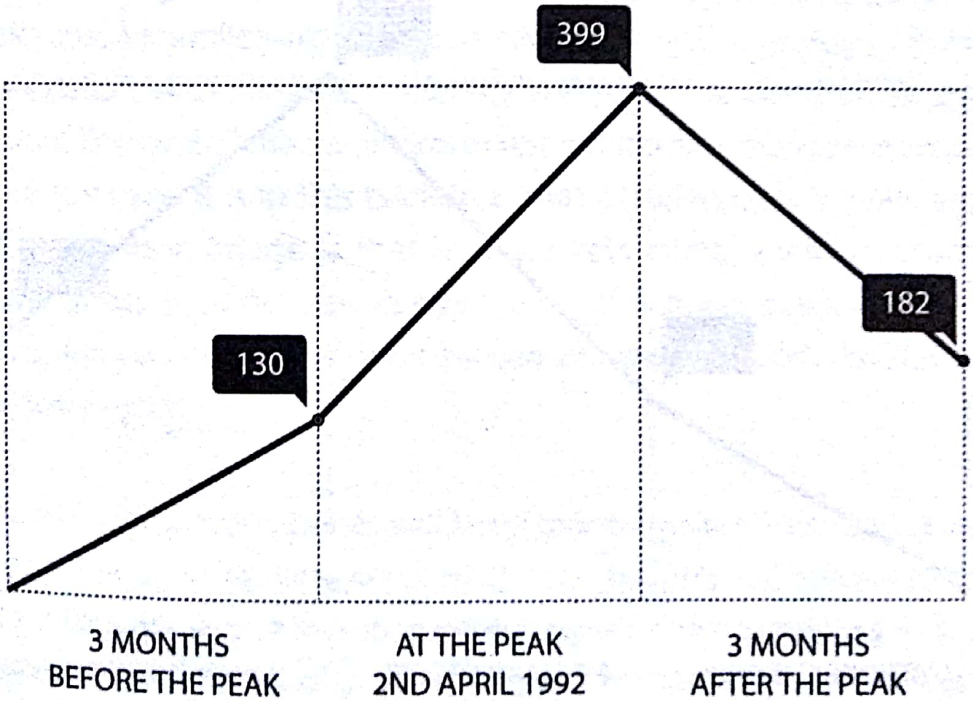
It therefore makes sense to wait for the bottom at which point prices will move sideways and consolidate whereas for the top there is no second chance because *if prices consolidate and remain at the top for a few days then that price is not a top whereas if prices retrace sharply downwards after hitting an already extended bull run in the circumstances listed above then the price that has been created could well be the top for several years to come.*

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THE RISE AND FALL OF THE SENSEX: THREE MONTHS BEFORE AND AFTER THE 1992 BULL MARKET PEAK

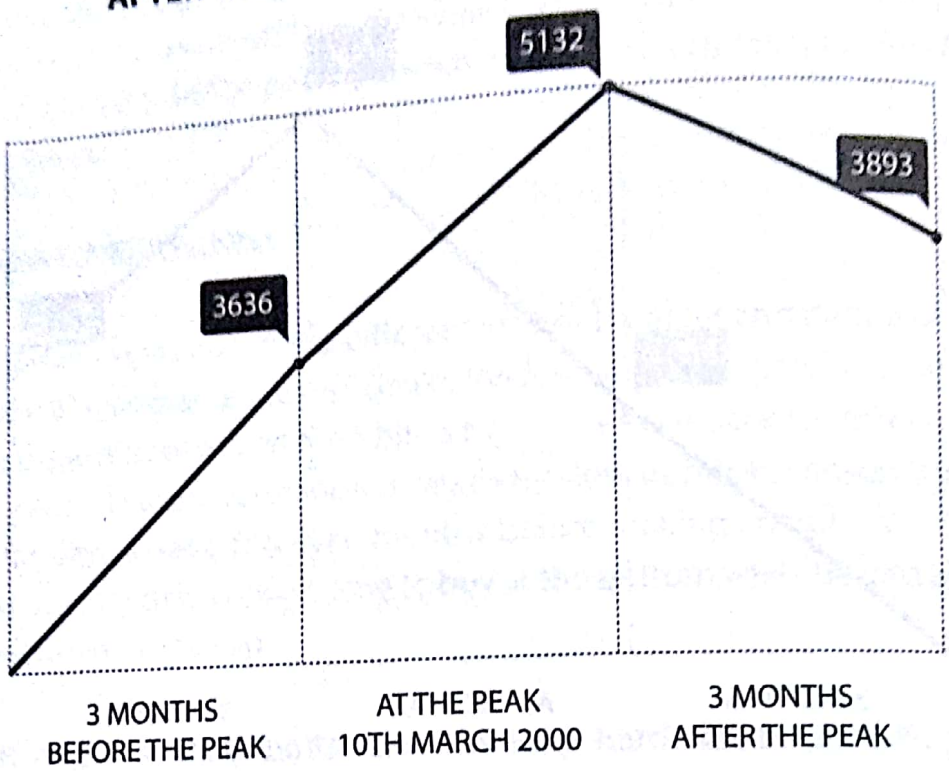


THE RISE AND FALL OF ACC: THREE MONTHS BEFORE AND AFTER THE 1992 BULL MARKET PEAK

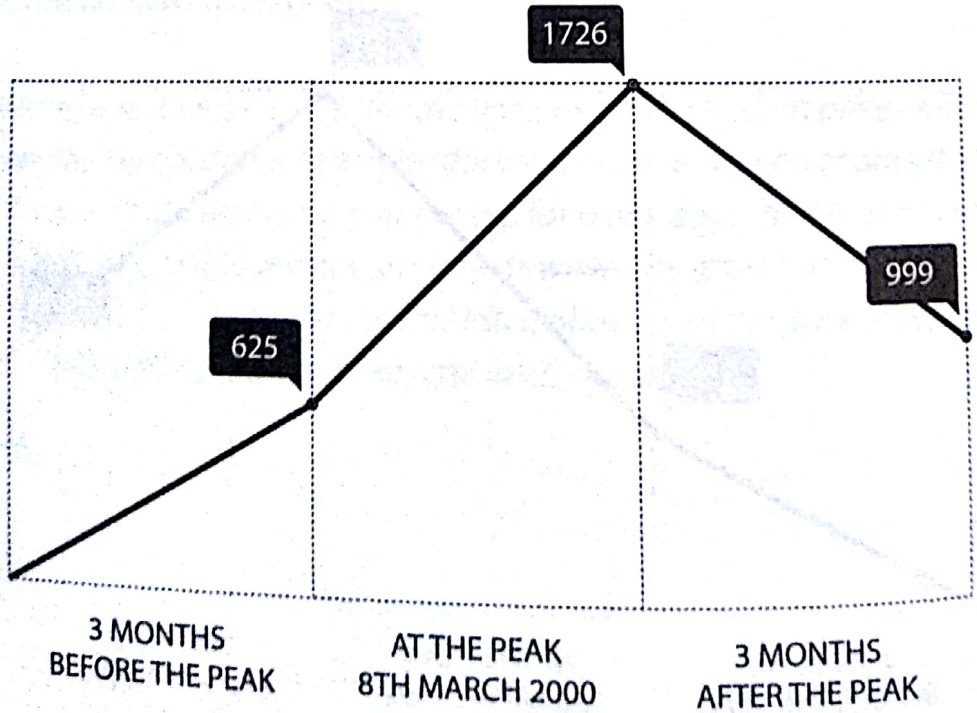


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THE RISE AND FALL OF THE NASDAQ: THREE MONTHS BEFORE AND AFTER THE 2000 TECHNOLOGY BUBBLE PEAK

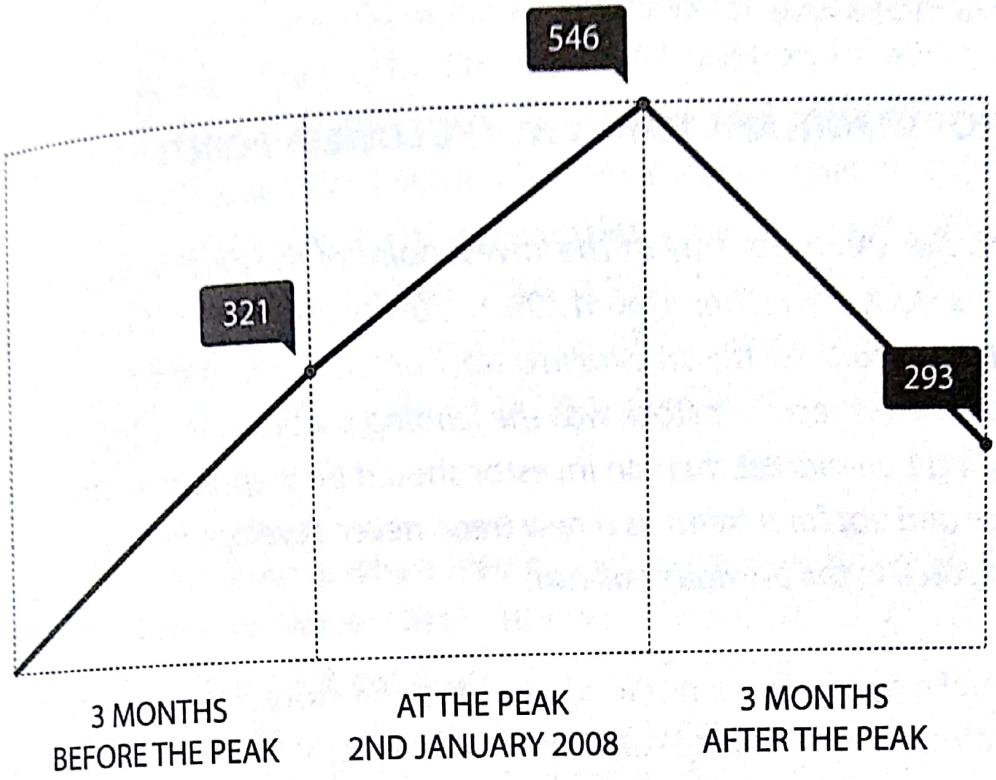


THE RISE AND FALL OF INFOSYS: THREE MONTHS BEFORE AND AFTER THE 2000 TECHNOLOGY BUBBLE PEAK



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THE RISE AND FALL OF UNITECH: THREE MONTHS BEFORE AND AFTER THE 2008 STOCK MARKET PEAK



In terms of market dynamics a) valuations are most reasonable at the bottom with prices being justified mostly by the P/E ratio, dividend yield or a price to book value b) public participation is minimum and c) leverage is very small or non-existent with minimum volatility and there is a sense of uneasy calm all around. The overall macro environment will continuously be throwing up bad numbers and it is in this backdrop that a bull marker is born again. In fact, the common adage is that bull markets climb a wall of worry and *whenever unexpected bad results don't push stock prices down its time to buy just as its time to sit back and ponder when unexpected good results can't take stock prices higher.*

While making a bottom, prices will keep going up and then retrace back to test its lowest point making what technical chartists call testing a bottom. At the bottom, the entire investing community is under-invested and under-leveraged and the threat of panic selling non-existent. The overall recovery

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after a long sideways movement will initially be strong but small. Each successive uptick will be met with selling from frustrated sellers and the market (buyers) keeps absorbing them as the stock(s) would show a slow but strong upmove.

IT IS NOT IMPORTANT TO BUY AT THE LOWEST POINT:

An investor need not buy *at the lowest point of the decline to make money. Buying a stock after it has moved 20% to 50% or even higher from the lows will also create wealth for the investor in a stock or sector that is starting a new trend. However, if the sector or stock was the leading participant to the immediately preceding bull market then an investor should be prepared to play only for a bounce and not for a trend as a new trend never develops in sectors that have participated in the previous bull run.*

The public generally rushes in to buy after the story has played out and the P/E ratios become affordable but that is exactly the thing that an astute investor should not be doing. If a bull market stock has had its run and then broken down violently from its high an investor should look at it only for a bounce or better still, not to look at it at all.

SECTORS TO PARTICIPATE IN THE RECOVERY:

As the market recovers from the bottom the first sector to participate in the recovery are the auto companies as the consumers who were putting off their vehicle purchases now come back to buy. The second sector to lead the recovery are generally the banking stocks which were earlier priced for non-recovery of loans and as the economy revives, the probability of these bad assets going under reduces. An increase in economic activity also encourages companies to expand business and hence take on further loans which increases the business of these lending agencies. Once the economy gains traction it then spills over to the industrials and the cyclicals which joins the party but with a lag, as the process of setting up new capacities happen only when the existing ones have been exhausted.

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WHY DON'T LEADING BULL MARKET STOCKS CROSS THEIR OLD HIGHS?

The leading stocks of the bull market takes a very long time to see their old prices, ACC conquered its 1992 high in 2005 whereas Infosys took six years to cross its high of ₹1,726 reached on March 08, 2000 while Wipro has still not been able to cross its 2000 bull market high of ₹980. Out of the leading stocks from the 2008 bull run, Larsen & Toubro is still 30% below its 2008 bull market high of ₹1,563. None of the real estate and infrastructure stocks of the 2008 rally have come anywhere close to their old highs. Pantaloon Retail is down more than 85% off its 2008 highs while Bharti Airtel is still down 40% off its 2008 bull market high of ₹575 with no chance of taking out its old highs in a hurry.

There are multiple reasons why a leading bull market sector does not cross its previous high in a hurry. Firstly, during a bull market the P/E gets so extended that even while earnings continue to grow, the process of P/E normalisation keeps a stock from moving up toward its old high, Secondly, the stock on the way down creates a flood of frustrated holders who look at every rise as an opportunity to sell just to recover their cost price back. Thirdly, as the industry grows in size and attracts attention, new entrants enter the space and reduce the company's ability to make higher profits thus impacting the economic viability of the business and finally there is a severe over-ownership bias for the stock and the sector, which makes it difficult to find new buyers as everyone who wanted to buy the stock already has a piece of it.

PAST BULL MARKET STOCKS CAN ONLY HAVE A BOUNCE AND NOT A TREND:

Unlike the tops, bottoms are made when the entire marker is filled with fear and pessimism. I bought a lot of beaten down names like Blue Star, Voltamp, Thermax etc in March 2009. While I could have caught these stocks a few months earlier when they were falling like nine pins, the long sideways movement of these stocks between October 2008 and March 2009 indicated that prices were fighting to make a bottom. This installed a sense of confidence that the marginal seller has been exhausted. *An investor should buy a stock*

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after it has traded in a range for a while so that one can get a sense that the absorbing capacity of the bulls is enough to match the ferocity of selling by the bears.

Though I sold out of these names after they had doubled and tripled in the next three to five months of buying, I later realised that what I bought at that time was just a bounce and not a trend. The question of a trend in infrastructure and construction stocks was out of question as these stocks were the darling of the 2003 to 2008 bull market so it would take these stocks several years of price consolidation to reach anywhere closer to their highs.

THE CROWD GETS IN TO BUY AFTER THE PEAK HAS BEEN MADE:

Most people generally get sucked in when stocks start moving down after hitting what could be called a fairly long term peak. *With the recency effect of assuming the immediate past winners to keep repeating themselves investors remain focused on buying the leading stocks of the immediately preceding bull market on every decline only after the story has finished.*

While most articles, papers and notes on value investing suggests that investors should stand away from the crowd and have their own independent thoughts when it comes to investing in the market the advice needs to be seen in the proper perspective. Going against the crowd is an option that an investor should think of only when the trend has been in vogue for a number of years and is showing signs of reversing. In general, it is very difficult to pinpoint the point of maximum enthusiasm or focus on the point of maximum pessimism and hence an investor should ride the trend in the backdrop of improving fundamentals. Of course, the trend that an investor should look out for is both the momentum of prices and the movement of earnings and revenues because as long as the earnings trend is in progress the prices will follow suit. Interestingly, the retail crowd does not participate as long as the original uptrend is in progress but as soon as the trend breaks down the small retail investor will come in to buy stocks that are cheaper in price though not necessarily so much in value because the new prices now discount the new perception of reduced earnings.

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Catching the bottom is however easier, as it gives an investor ample time to do so but buying shares just because they are falling does create more harm than good as what matters is not the quantum of the fall, but the stock and the sector which is experiencing the fall because leading bull market stocks rarely reverse their downtrend anytime soon.

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“Bad stocks that usually lead a market breakout rally are like the bad boys - good for late night partying but not for having as life partners!”

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Chapter 13

IDENTIFYING THE NEXT BIG TREND

Most investors remain focused on trying to find the next big trend rather than participate in the ongoing one.

Identifying the next big trend is all about looking for the 'new' whether it is a new sector, new stock, new high or new promoters but as investors like to be with the tried and the tested the new is not something that catches their attention immediately. Most investors would rather buy a stock in an old company from an old sector, run by an established promoter and available at old prices than go in for the 'new' making the identification of a new trend a little more difficult than what it normally is.

THERE IS ALWAYS A BULL MARKET - SOMEWHERE:

There is always a bull market in some asset class in some geography even as there is always a bear market in another asset class in the same or a different geography because we live in a world where assets are inflated in price by the arrival of liquidity and deflated in price by its departure and as liquidity leaves one asset class it enters another, causing a bear market in one asset to be balanced with a bull market in another. In the 1970's, when the Dow Jones was going nowhere gold, crude oil and silver were hitting new highs but as the Dow moved into a bull market from 1982, the price of gold, silver and crude oil stabilised and went nowhere for the next twenty years.

When technology stocks were plummeting after the Nasdaq bubble of 2000, a new bull market started to develop again in gold, silver, crude and other ferrous and non-ferrous metals which continued right till 2008. Later, gold and crude oil were pushing at new highs in 2008 even while the global financial markets were crumbling at the speed of knots.

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A theme based bull run raises a certain sector or a group of sectors to very high levels of valuation before putting it into a long period of secular decline. If caught well, one of these trends has enough power to create years of wealth in the quickest possible time. Stocks like Infosys and Unitech multiplied themselves several hundred times in five to seven years and turned a few lacs into several crores. Though most investors fear the bubble because of the consequences that it creates, a smart investor understands that if handled well, a bubble is similar to earning a lifetime of earnings in about 36 to 48 months of work.

DEFINING A BULL MARKET:

The theoretical definition of a bull market is a time when the index convincingly crosses its previous high by more than 10% and keeps making new highs thereafter. A bull market generally starts on a certain group of stocks within a couple of sectors and then spreads across to the broad market but the leading stock of the leading sector will be construed to be the leader or the poster boy of the bull market. *The critical distinguishing feature of a bull market is that the perceived wealth effect has to be endless and the investors should (wrongly) start assuming the period of prosperity to last forever.*

WHATEVER HAPPENS GLOBALLY HAPPENS IN INDIA:

One of the easiest ways to spot a new trend is to test whether the business has done well anywhere else in the world. While India lags the world in development, most of the new businesses that come to India do so after having already established themselves in the developed parts of the world. If in the 1980's investors made a lot of money in the multinational consumer names like Colgate, Nestlé and Hindustan Unilever it was because the business of selling toothpastes, coffee, soaps and shampoos had rewarded their shareholders in U.S and Europe. Subsequently, investors found it easier to bet on Zee TV in the early 1990's as media businesses had been proved for scalability and execution in the West. Philip Morris, remained the big bellwether for ITC. On the other hand, if investors lost tons of money betting on granite, aquaculture, renewable energy and micro finance companies it was because these businesses did not have a proven business model of

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having done a lot for their investors in a commercial form in the other parts of the world. When the Information Technology sector opened up for investment, computer and internet was booming in the developed world so the model was easy to relate to.

During the 1990's, investors who had seen how well mortgage financiers especially Fannie Mae and Freddie Mac had done in the U.S found it easier to understand the long term potential of HDFC. In the late 1970's, the U.S Government offered tax breaks on housing loans which put the mortgage industry on a multiyear growth path. Investors and analysts in India could have gone back to check on this when our government offered tax breaks on home mortgages a few years back. Subsequently, investors who knew about the long term growth trajectory of Wells Fargo and American Express could have found it easier to lap up HDFC Bank in its initial days of growth.

At the start of 2002, mobile telephony became a new trend and investors found it easier to buy the loss making Bharti Airtel by relating it to Vodafone, China Unicom and China Mobile. In between, long term investors were able to pick up Titan on the basis of the established business model of Tiffany, the international jewellery retailing company while the Pantaloon story looked more attractive when viewed with what Walmart had done in the U.S.

NEW SECTOR FOR EACH BULL MARKET:

The bull market always happens in stocks that were not the leaders in any of the previously concluded bull markets and would normally be a 'new sector'. For instance in the cement led 1992 bull run, very few knew about IT stocks (Infosys and Wipro). In the IT led bull run of 2000, no one knew what telecom (Bharti Airtel), retailing (Pantaloon Retail), infrastructure (L&T) and real estate (Unitech) stocks would look like and similarly in the infrastructure and real estate led 2008 bull run no one knew about cooker (TTK Prestige and Hawkins Cooker), pizza (Jubilant Foodworks) and underwear (Page Industries) stocks. The logic for each bull run being led by a fresh sector is that the underlying hypothesis of above average revenue growth cannot be expected to continue for two consecutive periods of time and slowly the

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This is because if there is a serious demand for IT Services the market sees on avalanche of new companies, providing IT Services and thereby exhausting the opportunity there.

Moreover, the general public becomes fully invested once leading bull market stocks start coming down after hitting the peak so *if these stocks were to go up over the next few years then everybody would become rich at the same time which is an economic impossibility.* For a sector to become a leading bull market company it has to have minimum public participation, investor ignorance and a general sense of disbelief for the business model of the companies in demand.

ABOVE AVERAGE COMPANY AND INDUSTRY GROWTH:

To make money from these bull market stocks an investor need not be the earliest buyer because once a trend develops it moves higher than what he thinks while after the trend terminates, prices fall lower to what he fears. The initial push to the trend comes from fundamentally strong businesses that are likely to be the bull market leaders of the new trend. The overall sector should work under a strong tailwind with buoyant growth. Right from the onset these companies will show rising sales, increasing profits, in an ever expanding market.

One way of identifying the trend will be to closely watch the revenue growth of most of the companies in a specific sector. When software was becoming a trend most of the technology companies including Infosys and Wipro were showing very high revenue growth. In 2003, the same format repeated itself with the infrastructure, capital goods and real estate companies like Larsen & Toubro, Nagarjuna Construction, BHEL and Unitech. Post 2009, onwards consumer, pharmaceutical and private financial stocks like Page Industries, TTK Prestige, Jubilant Foodworks Sun Pharmaceutical, Lupin and Gruh Finance were all showing very high revenue growth - both individually and collectively as a sector.

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SCALE OF OPPORTUNITY:

The new emerging trend that an investor hopes to capture will also have to be scalable. A scalable business is one where it is possible to grow the business as much through volumes as by pricing. An investor looking at new trends should try and estimate the market size in relation to the leading player in the segment. Generally, the market size will be several times the revenue of the sector leader and when the sector tops out like software in 2000, telecom, real estate and construction in 2008, the market cap of the leader will be worth a lot closer to the size of the sector. So as these bull markets ended the market caps of Infosys at ₹70,000 crores, Bharti Airtel at more than ₹200,000 crores, BHEL and L&T at more than ₹100,000 crores each was really significant when compared to the size of these sectors though in some cases like Bharti Airtel and Infosys the market cap of the company was well ahead of the sector revenues.

FIRST GENERATION ENTREPRENEURS:

Most companies that start a new trend are incubated by first generation entrepreneurs. So whether it was Microsoft, Dell, Facebook, Google, Infosys, Bharti, Pantaloon, Unitech all the promoters were first generation entrepreneurs without too much of a historical background with them. In the early part of 2003, when mobile telephony was being introduced Reliance, Tatas, Hutch, Essar and BPL preferred to go alone while Bharti Airtel had no option but to come to the public as while everyone had money to grow on their own Sunil Mittal needed external funding and so had to raise money by offering his shares to the public for subscription.

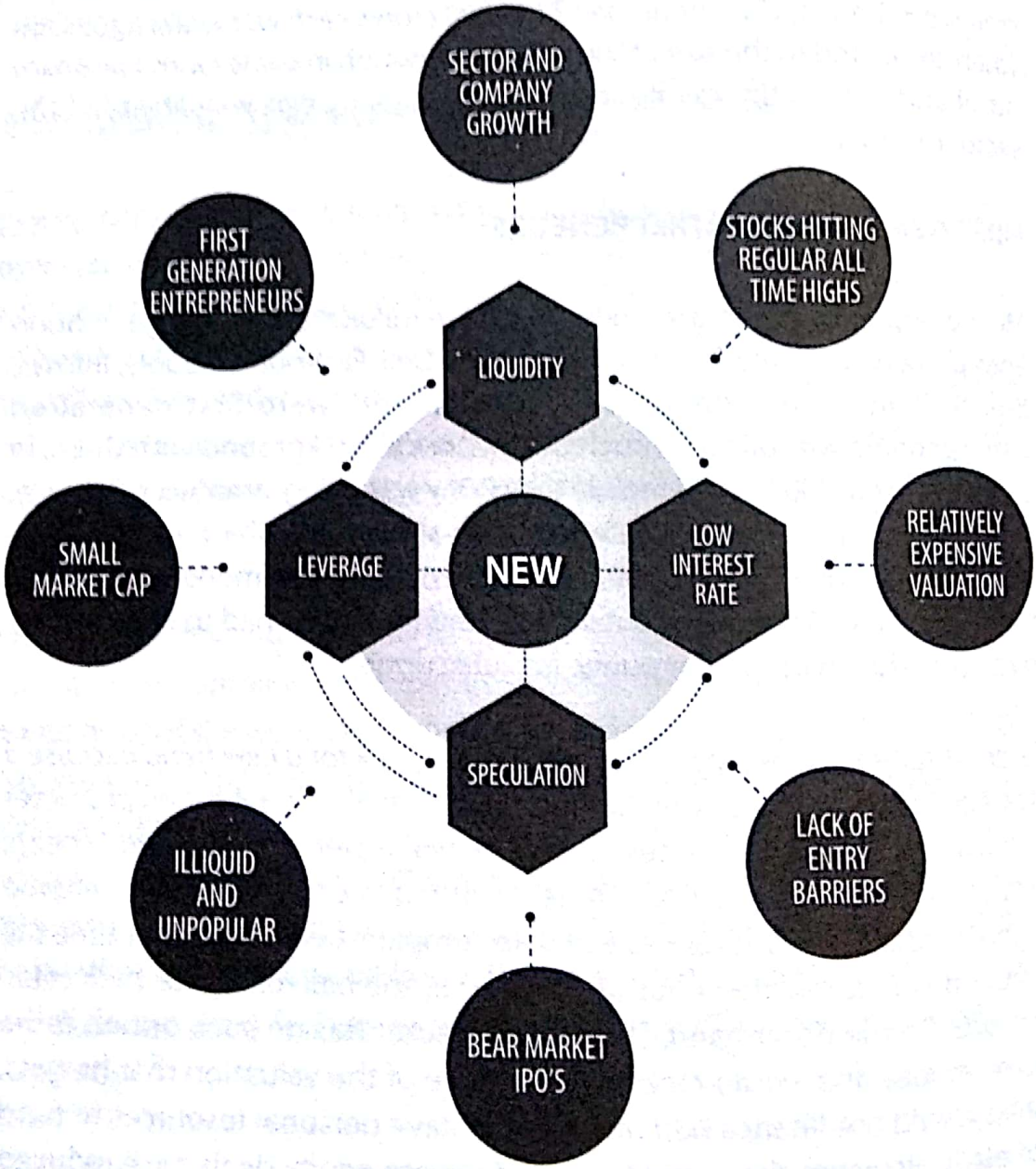
Established promoters are not the best place to look for a new trend because a new trend generally starts with the new blood. Even if an established promoter is starting a company in a new sector he will never sell his shares cheap. While Sunil Mittal brought Bharti Airtel for listing into the market he preferred to retain his retail endeavour as a private company because by that time the Mittals had accumulated enough cash to set the ball rolling for their retail venture. On the other hand, the new promoter has no such option as he needs money and would raise it irrespective of the valuation that he gets, banks would not finance him nor does he have personal resources to fund the plans. However, the current spate of private equity deals have reduced

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the options for the stock market investor as companies get funded by the private equity guys and are brought to the public only when the private equity investors are looking for an exit.

The difference between the established and the first generation entrepreneur is the lack of alternative opportunities. The newer breed of promoters have nothing to lose while on the other hand if an established entrepreneur were

HOW TO IDENTIFY THE NEXT BIG TREND?



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to mess up a new project he could land himself in trouble. The established industrialists prefer to take lesser risks and concentrate on their existing businesses rather than jump headlong into a new venture which in any case is very small for them to focus in the initial years of growth.

STOCKS HITTING ALL TIME HIGHS:

An investor should focus on the sector where most of the stocks have started to hit new all time highs. Leading bull market stocks are generally illiquid and start hitting new all time highs very quickly. *An investor should understand that stocks that start hitting new highs before the indices are more likely to extend their winning run in the next bull market.*

Buy low and sell high isn't the only way to make money. Wealth is also made by buying high and selling higher, a strategy shunned by most investors. A small or mid cap stock which gets into a fresh 52 week high does not stop at that but continues the trend and generally doubles in the next 12 to 18 months. There is no written fundamental logic on this but if an investor looks into the past history of how these stocks have behaved after breaking into a 'fresh' all time high he would understand that once a stock moves into a new high it goes further up rather than collapsing down as most amateur investors fear. Similarly, once a stock hits a new low it goes further down rather than moving up. The operative word here is 'fresh', that is if a stock has hit a high for the first time after a long consolidation and moves again next day it would be assumed to hit a high again but what will count is the day of the first move because the second high is an extension of the high hit on the first day and will not be construed to be a 'fresh' high i.e. a stock that goes to ₹100 on day 1; then to ₹107 on day 2 and ₹111 on day 3, would be construed to be hitting a high on each of these three days but an investor should take the day of first high i.e 100 as a point for computation of the desired double. The key to look out for is a new high after time consolidation. It applies to mid and large caps also but small caps move faster and higher, whereas the move in mid and large caps are stronger, surer but shorter but the double theory applies everywhere. However, in this analysis some kind of fundamental backing has to be there just mere movement of price beyond a level will not make it ready for that kind of a move.

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SMALL MARKET CAPS:

Most of the new bull market stocks will be sector leaders having small market cap. So whether it is an ITC, Asian Paints, Infosys, Unitech, TTK Prestige or Page Industries these companies were smaller capitalised companies to start with. A new trend generally starts in a sector where most of the companies will be smaller market cap companies. Most technology, media, infrastructure, retail and real estate companies had market caps of less than ₹200 crores to start with.

In 1984, Asian Paints was at a market cap of less than ₹25 crores while ITC traded at a market cap of ₹120 crores. The two stocks have since moved up almost 2000 times each.

RELATIVELY EXPENSIVE VALUATIONS:

Leading bull market stocks get expensive within the first twelve to eighteen months of price movement based on trailing earnings but would still be cheap on forward earnings. When the stock delivers on earning promises the markets start to put more trust on growth continuity and from current year earnings stocks start to discount earnings one year ahead. An investor could have bought a Bharti Airtel or a Unitech even one year after the bull run started and still made multiple times on his investment. *The actual threat to a bull market stock is not excessive valuation but slowing growth* as valuations remain expensive and then over-stretched till such time that the company keeps delivering above average rates of growth.

ILLIQUID AND UNPOPULAR:

Another aspect of catching early trending bull market stocks is that most of these companies will be thinly traded with high impact costs. Infosys traded a few hundred shares in 1995 and It was tough to accumulate even a reasonable quantity of Unitech and Page when these shares started making their first move. *An illiquid stock suggests that investors are willing to take a long term view without undergoing quick buy and sell decisions, it also suggests that the stock is unpopular and is not actively followed by the analysts and*

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research houses of Dalal Street. Another signal emitted by an illiquid stock is that with time and performance the liquidity and hence the P/E ratio of such stocks are bound to improve.

LACK OF ENTRY BARRIERS:

For a sector to become a leader of the bull market it has to have little barriers to entry. This is interesting because in general an investor looks for a company with high barriers to entry whereas if a cluster of such companies constituting a sector have to become the new trend they have to have little entry barriers. This is so because a new trend suggests a small number of companies growing in scale and size with the new entrants joining in to increase the investment pie. A spate of IPOs towards the end of the run is important and with very high entry barriers it will become difficult for new companies to join in. *New companies with questionable management integrity is the necessary catalyst that causes a bull market bubble to burst.* An investor can argue that if this is the case then can a bull market be formed out of consumer or pharmaceutical stocks? The answer to this is that these two sectors with high barriers to entry can see a bull market but not a bull market frenzy like it happened to IT stocks in 2000 or construction and real estate stocks of 2008.

BEAR MARKET IPO'S:

Contrary to popular perception, most of the emerging companies are presented to investors through the initial public offering (IPO) route during a bear market. If the sector is new then by logic it would not have too many companies listed in the market so whether it was Zee TV, Infosys, Bharti Airtel, Page Industries, Jubilant Foodworks the IPO was the only way to get them out to the public. An astute investor should therefore have a keen eye on the companies coming for an IPO rather than brushing aside all IPOs with the old fashioned cliche of 'Its probably overpriced'. If there are ten IPOs in a bull market than maybe nine of them will be bad but if there are five IPOs in a bear market than one of them could be a potential multibagger. So if there is a bear market around it makes sense for an investor to have a closer look at the IPO market rather than ignoring these new companies with the traditional mindset.

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Instead of spending time researching their investments most investors keep worrying on what the other investors of the investment are doing. Many companies that come through the IPO route do so to provide an exit to their original private equity investors. A company that has worked with a private equity team before coming for an IPO is generally assumed to have modelled its business well. At the time of the IPO most commentators would dismiss such stocks stating that if the prospects were so good why are the private equity investors deserting it?

Two reasons why private equity investors sell a stock is because a) they have found a better option elsewhere or b) the mandate or the time period of the fund has ended and its time to pick up the cash and return it back to the original investors of the fund.

Jubilant Foodworks, Repco Home Finance and Just Dial are three companies that came to the market because their original investors needed an exit and all these three businesses have done pretty well post the IPO.

Many investors ignore buying an IPO stock with the argument that such companies do not have a listed operating history and wait for a company to deliver above average growth for a few quarters before buying the stock by which time the stock already makes its move as *good companies are seldom available cheap nor do these businesses wait for their prospective investors to get in before making their next move up.*

The red herring prospectus has the operating history of a company which can be used to evaluate the past financials of the company for as many years as is required so that whether the company was listed or not has little bearing on the analysis.

PICKAXE AND SHOVEL THEME:

As bull market stocks are expensive some investors look at playing it through the pickaxe and shovel theme which has been created out of the great 19th century California gold rush. At that time, the large gold deposits of California attracted a lot of people to come and dig for gold. A small part of the

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population started supplying pick axe and shovels to the miners looking for gold as while it wasn't certain that a miner would be able to get gold it was clear that he would buy pick axe and shovels which would help him dig for it. The suppliers were soon making more money than the diggers. It was during this time that Levi Strauss had developed the 'jeans' which was initially a thick material trouser made from canvas and later improvised with denim as these trousers lasted long enough and helped the miners stay focused on their gold quest rather than remaining worried about putting patches on their trouser holes after returning back from work.

Taking the California gold rush argument forward, sometimes when a sector reaches an extended level of valuation an investor tries to identify companies that will gain from the economic benefits of the underlying theme instead of buying the direct beneficiaries. The advent, development and spread of the internet increased the efficiency levels of the user sectors in the economy. An investor could have thus looked at HDFC Bank as a beneficiary of the computerisation and internet drive and bought the stock which is up 13 times since 2000. Later, as the IT Enabled Services and the BPO boom took over an investor could have looked at Avaya Global which used to distribute equipments used up in the outsourcing industry. But in this case, the stock did not do well because its earnings and revenues refused to grow as much as the leading IT Enabled Services and BPO players and the market refused to take the stock up as it did to stocks like E-serve and Mphasis BFL. Moreover, the foreign parent at Avaya Global tinkered with the business model and removed the profitable part of the business from it, which was enough of a signal for an astute investor to move out.

As the mobile culture exploded in India, HCL Infosystems an India franchise for Nokia made a lot of money because everyone getting a mobile connection had to first buy a handset. Later on, when the real estate and infrastructure, boom caught up all the shopping malls, offices, airports and high rise establishments had to be centrally air conditioned and Blue Star growing revenues and profits at a CAGR of 30% and 41% respectively moved up 30 times between 2003 and 2008. As the auto industry grew in the past decade, battery manufacturers like Exide and Amara Raja did well because even though there were more than ten car manufacturers around, the two battery suppliers have moved up 25 and 90 times respectively between 2003 and

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2013. Amara Raja also benefitted from the growth in the telecom industry as it supplied batteries to be put up in the telecom towers and even while they price their product higher to the competitors, the buyers keep returning back because of the product quality. Similarly, if internet shopping and e-commerce becomes a big industry then courier companies will have a good time. In this connection, Blue Dart is already up 60 times in the last ten years. However, most investors run to the service providers because they are cheap in valuation which by itself is a gross mistake. The shares of the service providers will only do well if they can grow at a faster or similar rate than the industries to which these companies provide a service to. Blue Star did well because it grew at a similar clip to Larsen and Toubro, Amara Raja did well because not only did it grow faster to the car manufacturers but also to Exide. Avaya Global did not do well because it lagged the BPO players in terms of revenue and earnings growth so even while looking at the pick axe and shovel theory a company will do well only on the basis of its own earnings growth only.

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Chapter 14

IS SEMI-URBAN AND RURAL INDIA THE NEXT BIG TREND?

Most investors chase stocks that will make them money rather than sit with the ones that will create wealth.

Semi-urban and rural India have long been left ignored by the stock market. There was a time when most investors used to focus on companies that catered only to the larger and developed areas of the country but the overall equation has changed in the last few years as the underdeveloped parts of the country are now showing signs of a strong growth. More and more companies are now shifting focus to addressing the large untapped opportunities of 'Bharat' as these parts of the country are generally referred to as.

THE TRIGGERS:

The past few years have seen semi-urban and rural India undergo a strong and steady increase in disposable income. The initial catalyst for this increase in income was the farm loan waiver in 2008 which put ₹60,000 crores directly into the hands of the rural population. Sometime before that, the government launched its Mahatma Gandhi National Rural Employment Guarantee scheme (NREGA) which guaranteed an employment of at least a 100 days in a year to every citizen which put more money in the hands of the rural labourer. Thereafter, the government implemented the 6th pay commission report which resulted in a significant increase in salary of all government employees both in urban and rural India. Subsequently, the rise in prices of food articles, especially fruits and vegetable have compulsively led to a redistribution of income from the rich to the poor or from urban India to semi-urban and rural India.

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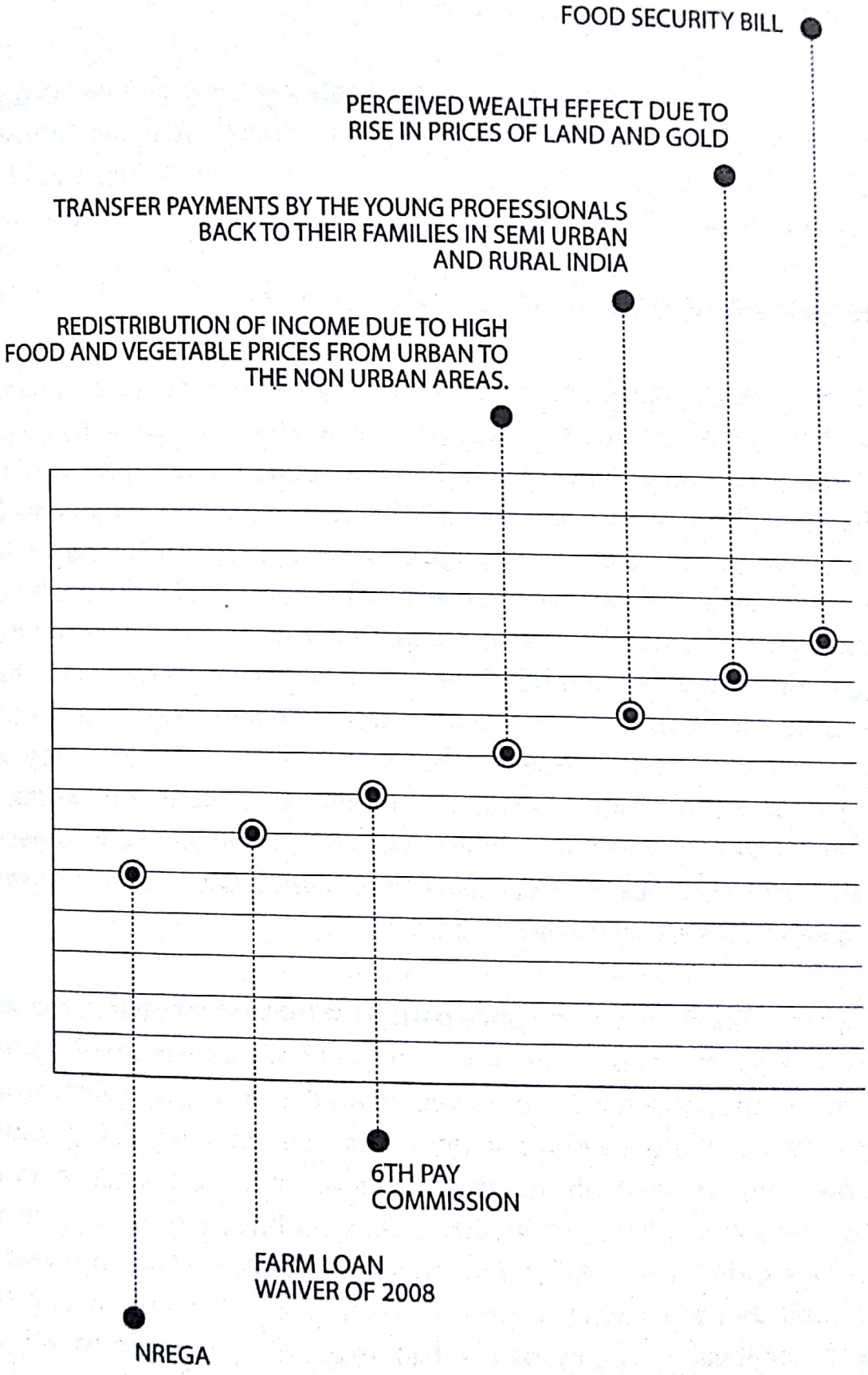
The mid-day meal scheme started by the government in villages which provides free food to students attending school has encouraged an increasing percentage of rural population to undergo formal education. The spread of literacy has made a larger number of rural students to pursue higher studies and thereby seek better employment opportunities. These professionals are now sending back remittences to their family in the small towns and villages which is again augmenting the purchasing power of semi-urban and rural India. Finally, there has been a stupendous increase in the price of both land and gold over the past few years and as gold and land remain the two major avenues of parking income for folks staying in the semi-urban and rural areas an increase in the price of these two asset classes have caused a wealth effect, where an enhanced level of incremental income is now being diverted for consumption.

During the last decade, India's per capita income crossed the $1,000 mark. When a country's per capital income crosses this figure its citizens use a little more money for discretionary spending than what they were doing before. This causes the overall spending basket to move away from the essentials of food, clothing and shelter to the products and services that provide more comfort to an aspirational consumer. Consequently there has been a demand for all types of consumer goods and if a country's citizens are making a lot of incremental money most of them would need avenues for parking the surplus and also for leveraging their existing income giving rise to a growth in the businesses of both the consumption and the financial services sector.

With rising incomes, farmers are bound to employ better methods of agriculture which includes mechanisation and use of better quality seeds and fertilisers. The Gujarat government's river interlinking project has already borne fruit as it has reduced the dependence of monsoon for farm irrigation and has encouraged the farmers to go in for multiple crop harvesting. Madhya Pradesh has already initiated the process of interlinking the Narmada and the Shipra rivers and once such interlinking projects start to happen on a pan India basis, it would further increase the income of the rural farmer and the country could see a significant and sustained increase in rural and semi-urban income.

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FACTORS CAUSING AN INCREASE OF DISPOSABLE INCOME IN SEMI-URBAN AND RURAL INDIA.



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These efforts assisted by the improving communication links through better roads, telecommunication, electricity and banking are all contributing to making semi-urban and rural India a better place to work from in comparison to what it was, about a decade back.

Finally, the 'Food Security Bill' which should start getting implemented soon will supplement the rural household with subsidised food items. This saving in cost will lead to a further increase in disposable income which would help boost the consumption in the semi-urban and rural areas of the country.

THE STOCK MARKET IS ALREADY CELEBRATING:

From the stock market point of view the consumers and the private financials have been on a sustained growth path since 2008. The growth has been higher for companies that cater to the under penetrated segments of rural India. So while pressure cooker is assumed to be have penetrated only 20% of rural homes, stocks of TTK Prestige and Hawkins are up 30 and 12 times respectively. The first aspiration of every Indian household is to have his own house, so Gruh finance the rural mortgage financier is also up 12 times; stocks of specialised rural lending NBFCs like M&M Finance have gone up 6 times while price of the underwear manufacturer Page Industries is up 15 times since March 2009 as the the semi-urban market is booming for Jockey. With rising incomes, more Indians will eat out and so Jubilant Foodworks, the dominos pizza franchise is up 6 times since 2010, while other consumer and private financial names like ITC, Asian Paints, Marico, Bata, Godrej Consumer and Kaveri Seeds are all up by 3 to 7 times.

A look at the financial and the price pattern of these stocks tell us the story. All these consumer and private financial stocks are showing high revenue growth and though a few have slowed down the slowdown seems to be a temporary growth de-acceleration rather than a trend reversal. These stocks have been hitting new highs together and most of these are still unpopular as they trade at smaller market caps. Even after having moved up several times Page Industries is still at a market cap of $900 million with years of growth still ahead of it; while Gruh Finance at $700 million is nowhere close to its terminal value. The market is itself expanding at a decent rate and

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though these sectors aren't new, valuations have been considered expensive by many in the investing community even as these companies are increasing profitability at higher rates which is a fair signal for a bull market stock.

Most companies in their interaction with investors have also suggested that semi-urban and rural India faces very little slowdown when compared to the top metro cities in India. It seems that the slowdown in India is more pronounced in the homes that watch CNBC than in the homes that don't.

Whether this new trend will develop into a large market is still uncertain but what is certain is that most of the companies making up for the semi-urban and rural consumption theme are still very young and have years of growth ahead of them and with 50% of India's population below the age of 25 and 65% below the age of 35, the youth represents one of the biggest areas of opportunity and companies that can capitalise on it stand to create tremendous wealth for their shareholders.

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“There would be no market, if everyone thought the same and did the same.”

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Chapter 15

UNDERSTANDING BUSINESS MODELS

In the stock market one can't buy mangoes at the price of bananas.

Most investors remain focused on arguing about the valuation at which a stock trades at rather than on evaluating the business model of a company they intend to invest in. In this connection, it is important to understand that evaluating the business model of a company forms an integral part of stock analysis as the mode and nature of business is more important than the valuation metrics. *This is because in the long run a good business can mend a bad balance sheet and a bad business can destroy a good one.*

WHAT CONSTITUTES A GOOD BUSINESS?

A good business is one that purchases on credit and sells on cash. Purchasing on credit indicates that there is plenty of competition amongst the suppliers while selling on cash means that the buyers are weak and dispersed. Both these attributes shifts the bargaining power of the business to the company. Additionally, if sales are happening for cash, it reflects that the product* is in demand and the company does not have to keep a high inventory. This coupled with an excess of creditors over debtors because of the credit purchases and cash sales would keep the working capital in check while taking it negative at times. *With increase in scale of operations, a negative working capital company would accumulate cash as it receives more credit for its purchases while customers deposit instant cash for the sales that the company*

*in this chapter and elsewhere the term product also includes the activities of services which has to be seen in the overall context of the argument.

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makes to them. Such a company uses the credit period from creditors to finance its short term requirement and even undertakes large scale expansion without employing a lot of its own money. The fact that customers pay upfront while creditors wait for payments is a reasonable indication of an entry barrier which ensures that the company's market and margins remain insulated from repeated competitor attacks.

A good business will necessarily generate a high Return on Equity (RoE) without employing too much debt and follow an asset light model where investments in fixed assets like plant and machinery is relatively low even while the working capital remains negative as elaborated above. Some companies like Symphony maintain an asset light model by outsourcing the manufacture of their products to third parties while focusing on the quality standards of the same thus operating as a mere design and marketing enterprise, an endeavour when coupled with a negative working capital makes for an asset light model. This combination leads to a high asset turnover ratio which indicates that a rupee of asset generates sales that is several times higher than the investment.

ENTRY BARRIERS:

A business can have an economic moat which is defined as an entry barrier through various sources. These barriers to entry help the company in maintaining its leadership status and also in widening the gap between the company and its nearest competitor. The idea of looking at businesses from the perspective of entry barriers or moats was originally presented by Warren Buffett. Large profitable enterprises attract competition and unless a firm can retain its competitive strengths through a high entry barrier it becomes difficult to generate above average levels of profitability over longer periods of time. Having a strong barrier to entry also helps the company in maintaining a high pricing power because it restricts the competition from getting in to sell at a lower price.

BRANDS:

A brand is the most important entry barrier to a business. A product becomes a brand after creating years of consistent customer delight. Mere customer

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satisfaction isn't enough as a product or service creates customer delight only when it starts capturing a part of the customer's mindshare. Mindshare capture is considered superior to market share capture and indicates high product recall irrespective of price changes. A product that has captured mindshare *sells more on word of mouth and need less of advertising compared to a product that has just captured market share.* The ultimate point of mindshare capture is to see a brand name become a generic recall for the product. For instance, people talk of getting a paper photocopied as getting it 'xerox', decorative laminates are termed as 'Sunmica', or chocolates being popularly known as 'Cadbury'.

MARKET SHARE VS. MINDSHARE:

The debate between mindshare and market share is normal. *The analyst community generally focuses on market share because it is quantifiable and can be easily deciphered through numbers whereas computing mindshare is a subjective exercise with unquantifiable arguments.* Hence, if an investor can see a company capturing mindshare rather than market share he should pay more stress on analysing mindshare rather than market share. In most cases, mindshare capture can be dichotomised from capturing market share because market share capture is a mass market exercise based on pricing policy and is generally focused on distribution and reach. Mindshare capture on the other hand is not based on pricing and distribution strategies as it originates from the ability of the product quality to come good to the customer's expectation while creating customer delight.

A company captures market share by pushing its products towards its customers either through lucrative pricing or better distribution or advertising whereas mindshare capture is more of a pull strategy where the customer himself comes looking for the product not because he has seen its advertisements but because he perceives the product to be of superior quality with a more than sufficient utility.

FRANCHISE LED GROWTH:

Most companies with strong brands appoint franchises for selling their products to the last mile consumer. Such franchises or distributors buy products from the company and sell them through their showrooms or the

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EBOs (Exclusive Business Outlets). These franchises are appointed on the basis of either products or geographies. As business grows, the company breaks up each of the areas to appoint more franchises in the same geography or appoints a new franchise in the same area by taking away a product from the existing franchise. This is because these franchises are family run businesses and generally have little incentive to grow consistently year on year.

Most companies also keep calculating the RoE of the franchise so as to ensure that the franchise owner make around 17% to 18% return on their capital. This return calibration is necessary to ensure that a franchise does not make too much return but also remains incentivised to continue in business. As these brands earn around 30% to 50% return on equity the introduction of these franchises helps them increase their own RoEs. A company that grows on the franchise model needs a lesser amount of capital to operate as its growth is largely funded by the deposits and advances that it receives from its franchises. *If the brand is strong then the shareholders of the company will make more money than the franchise owners but having a franchise led business model is not a sure sign of success because while the shareholders of Jubilant Foodworks and Titan have prospered on this model the minority investors of the oil marketing companies like HPCL, BPCL and the garment retailer like Raymonds have continued to lag behind the franchise owners.* This is because a distribution strategy cannot add too much to a business if the management cannot run the business in the interest of the minority owners.

CHANGING THE METRIC OF MEASUREMENT:

Generally, companies that change the metric of measurement are known to possess very strong pricing powers which leads up to a robust business model. A change of measurement occurs when a company buys in weight and sells in pieces. For example, a pharmaceutical company buys its raw material by weight and sells its drugs in pieces, Jubilant Foodworks does the same, buying raw material by weight and selling pizzas by pieces. Biscuits, cigarettes, liquor, soaps and shampoos are also sold the same way making these businesses very strong brands with enormous pricing power.

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Changing the metric of measurement is one of the most important signals of pricing power, but high growth with high pricing power is a rarity as most high pricing power businesses are niche product companies where it becomes difficult to expand the market beyond a certain rate of growth.

An investor who can identify a company with high growth and high pricing power in the initial days of discovery has probably found a potential multibagger.

HIGH GROSS MARGINS:

Companies with pricing power also report very high gross margins because they are able to charge a lot more for their conversion costs. The range of gross margin for companies with strong moats range from 50% to 60%. In other words, for every ₹100 worth of goods sold, these companies report a raw material consumption level of ₹50 to ₹40 only.

GOVERNMENT LEASE:

Companies that operate out of a government awarded lease or license also carry an entry barrier which prohibits competition from getting into its business. A government lease or licenses could be the mining rights to extract a certain mineral or exclusive permission to collect toll on an expressway or any other right bestowed by government order.

PATENTS:

Patents are a set of exclusive rights given by the government to an inventor of a product or a process to develop a certain product. These rights stay with the inventor for a certain period of time during which no other person or company can produce the stated product or use the patented process without exclusive permission of the person holding the patent.

Most of the patents are granted in the field of medicine and technology and once a company is awarded a patent it gets entitled to making above average profits for the entire length of the patent period. This creates a huge entry barrier for any competitor from getting into the business.

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Generally, companies that benefit from intangible assets like brands and patents have the best returns on capital because it allows the company to charge more for its products irrespective of input price movements as even if the business becomes lucrative, the entry barrier restricts the competition from getting in.

LOW COST OF PRODUCTION AND ECONOMIES OF SCALE:

Companies that operate with a very low cost of production also creates entry barriers for present and prospective competitors. A low cost of production also originates from economies of scale. Walmart, the world's largest retailing company survived the last four decades because of its low cost of operations. It is said that its promoter 'Sam Walton' used to drive a truck to work! Generally, companies that have a low cost of production are able to sell at lower prices while making sufficient return on capital.

Being the lowest cost producer is more relevant for a company selling a commoditised product as it enables it to stay economically viable at all times and helps it earn maximum profit on an upturn. *The entry barriers to the lowest cost producer are also very high but unlike a company with a brand or a patent which can charge a high price for its product the low cost producer can only curtail costs to a certain extent. Costs cannot be cut by 100% whereas some consumer products and drugs are known to charge several times above their cost of production.* This puts the company with a low cost equation at a certain disadvantage to another company with pricing power because the power to raise prices significantly outweighs the ability to cut costs. Given a choice between the two, an investor should at an appropriate valuation, look for a company that can raise prices rather than stay with one that can only cut costs.

LARGE UPFRONT CAPITAL EXPENDITURE:

Some companies enhance their ability to fight competitive challenges by putting up a heavy capital expenditure to create large economies of scale. The Indian Railways is one example where the amount of capital put upfront to create economies of scale is so large that it acts as a deterrent to any

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competitor from entering the space. The working of the railways under a social and welfare motive also discourages it from making normal economic profits. The idea of creating efficient scale involves putting up a lot of capital upfront and though these companies operate with some kind of product uniqueness their moat can bring them uninterrupted profits for longer periods of time.

The sheer scale of capital involved in these kind of companies ensures that the return on capital employed remains low and unattractive for any competitor to breakthrough the business. In contrast to the 'Indian Railways' is the Indian air travel market where the lack of entry barriers coupled with the spiralling price of crude oil has made it really difficult for any company to make more than normal rate of return maybe that is why we have had over a dozen airlines over the last twenty years with more than 75% closing down but no competition in the business of rail travel. After all, who will look to set up the tracks before running his own train?

NETWORK EFFECT AND SWITCHING COSTS:

The network effect for a company is created by the customers of the business rather than the people managing the business. Most social media websites work with this network effect. *Just because more people log in to check Facebook it compels friends, relatives and acquaintances to remain hooked on Facebook making the franchise more popular and valuable.* The network effect also works with companies that sells its products online, for example ebay draws more sellers just because more people use eBay for buying goods. In the late 1990's, Microsoft had this advantage through its operating system 'Windows' and then through internet explorer where almost the entire PC market remained under the direct control of Microsoft. However, unlike a brand or a patent the network effect does not ensure higher profit margins through higher selling prices. It ensures that the leader of the industry retains a major chunk of the market and enables the winner to grab a major chunk of profits.

In the Indian context, HDFC Bank exploited this strategy very well ever since it started operations in the mid nineties. It first became a banker to the National Stock Exchange (NSE), which made all the brokers of NSE to open

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their accounts with it so that the fund transfer could take place on the same day without delay. Subsequently, having the brokers operating through HDFC Bank also compelled the clients to move to the same bank. It is estimated that over the past fifteen years HDFC Bank has cornered a major chunk of the high quality individual and corporate accounts and retains it through the network effect making it extremely difficult for any new bank to capture market share away from it.

The concept of 'winners take all' is an exciting feature of evaluating a good business. In 'Bollywood' the top 50 participants either in the form of actors, directors, musicians and producers take home 80% of the revenues whereas the thousands of other industry workers struggle for the balance 20%. Similarly, with Google and Facebook the winners take home 80% to 90% of the industry revenues while the others struggle for the balance. Similarly, in the health drink market, GSK Consumer through 'Horlicks' has a 80% share making it very tough for a new entrant to get into the business.

The switching cost of a customer arises from the inconveniences that customers face when they move out of the network effect. Mobile telephony companies were able to hold back their customers when number portability was not in vogue as customers switching to a new network would have had to forego their existing number for a new one.

PRODUCT PENETRATION AND DISTRIBUTION NETWORK:

Unless the market itself is under-penetrated an investor should focus more on stocks that sells items of repeated use. A washing machine or a television set gets a buyer once every seven years when compared to a bottle of shampoo that gets a buyer every month. However, in a country like India consumers need not buy the product for replacement demand only as first time customers also queue up to buy a product which is under-penetrated. This generates a sustainable demand for products that have a long replacement cycle because the first time users join in to supplement the long replacement cycle. The ability of a company to increase product penetration is also dependent on its distribution network. Having a strong network of distribution remains one of the most important aspects of creating an entry barrier for any new entrant.

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An investor analysing companies should understand that if the replacement cycle is high, the penetration level has to be low (cookers) and if the penetration level is high, the replacement cycle has to be low (cigarettes).

LOW PRICED ITEMS:

Companies which sell low ticket price items forming a small percentage of the overall consumer disposable income find it easier to raise prices than companies which sell items that constitute a larger part of the customer's disposable income. A newspaper company raising its price by 20% will not find as much resistance from the buyer than a car company that raises the price of its product by even half that amount. This is because a customer's allocation to buying newspapers forms a very small part of his overall spending basket when compared to making monthly instalment payments after he has bought the car.

POSSIBILITY OF POSTPONEMENT:

Products whose buying can be postponed by the buyer isn't such a good business as a product whose buying needs immediate action by the buyer. This is why pharmaceuticals and FMCG are considered to be better businesses than that of selling cars and two wheelers. While an investor can easily postpone the purchase of a car by a year postponing the purchase of medicine is almost impossible.

An investor who intends to buy stocks should evaluate the business model of a company with as much seriousness and vigour as he looks up to the financial statement of the company in question. A simple way of getting around the problem of avoiding companies with weak business models is to invest in sector leaders. *The leading stocks of each of the sector will either have a strong brand, patent or will be a low cost producer or have a high network effect, while going down the ladder to look at the second or third best company in the sector exposes the investor to the incremental threats of business risk.*

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“Investing should be about either making a 'few' if not 'many' but under no circumstances losing 'any'.”

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Chapter 16

TOOLS OF FINANCIAL STATEMENT ANALYSIS

The classic psychology of an average stock market participant is that he always wants to buy and sell today's stock at yesterday's price.

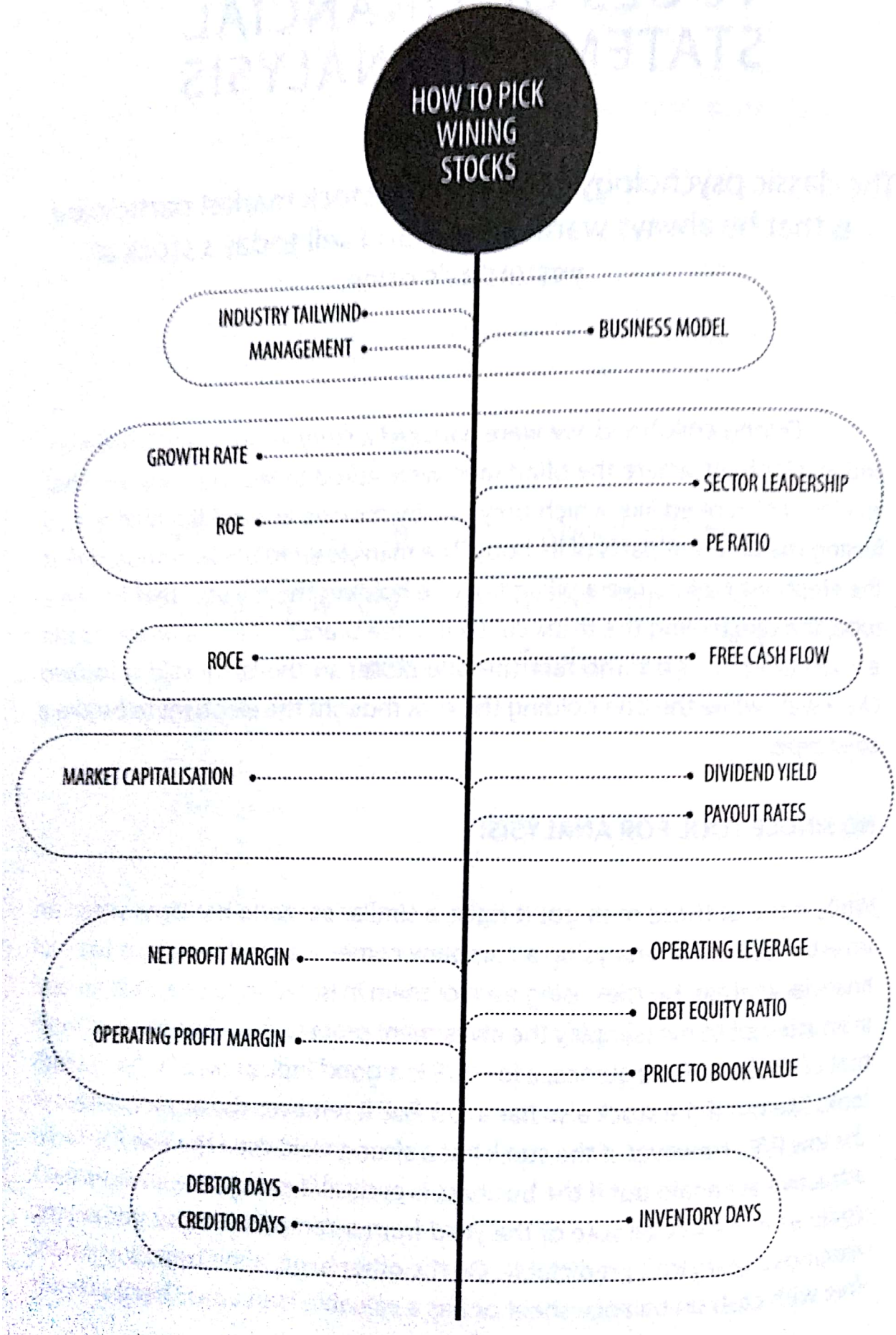
During childhood, we were narrated a story about a few blind men and an elephant where the blind men were asked to feel and explain what an elephant looked like which they did, by moving around the animal and feeling the different parts of its body. The man closer to the leg thought that the elephant looked like a pillar; the one holding the tail said that its like a rope; the one feeling the trunk called it a tree branch; the one nearer to the ear declared it as a hand fan; the one closer to the belly said it looked like a wall; while the one holding the tusk thought the elephant to be like a solid pipe.

NO SINGLE TOOL FOR ANALYSIS:

While none of these men got it right, a similar scenario happens when an investor looking at analysing a company comes across the various tools of financial analysis. He tries using each of them in isolation to one another and in an attempt to oversimplify the investment process, gets fixated on a single tool of analysis. For instance, a low P/E is a good indication of what a stock looks like but if the stock also has a low RoE it removes the attractiveness of the low P/E. However, if the stock has a strong yield then the low P/E looks attractive yet again but if the business is cyclical it swings the analysis back again as one can't be sure of the yield from a company whose underlying earnings stream isn't predictable. On the other hand, if the company is debt free with cash on balance sheet or has a valuable land bank that it intends

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HOW TO PICK WINNING STOCKS



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to monetise for the benefit of its minority shareholders the stock might look attractive yet again but if the management isn't clean then the land bank is of little use to the minority shareholders. A company with free cash flow will be considered investment grade but if the sector is cyclical with a dwindling order book or an uncertain outlook on the price of the underlying commodity then the free cash flow isn't of much use either.

Even if everything else looks attractive a stock that is consistently hitting new lows might make an investor stay back a bit before taking a large bet as maybe the market knows a little more than what he does.

The stock market has no fixed rules as all watertight notions on valuations and strategies, when used in isolation are subject to abrupt failure. The operative word here is 'isolation' because the tools of financial analysis serve their purpose only when they are used concurrently to one another. Its only the collective aggregation of data that helps an investor in formulating an investment opinion on the stock. However, while looking at aggregate numbers one could increase the weight of some aspect while reducing the importance of the other depending on the overall market sentiment and the risk profile of an investor but there will never be a one tool fits all concept as all numbers are interlinked and dependent on each other.

So when a new stock idea comes up, the investor's mind should start thinking in multiple ways as a stock cannot be attractive on all counts. Companies that have strong business models are expensive on the P/E ratio front whereas cheap companies have businesses that can be challenged by competition. Trying to find the best business at the lowest valuation is an exercise that remains unaccomplished almost all the time.

TOOLS OF FINANCIAL ANALYSIS:

Considering all these aspects mentioned above the various tools for evaluating an investment idea are indicated below. As argued above, the usefulness of these tools increases when used together rather than in isolation.

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BETA:

This is a temporary measure of stock price volatility and is viewed in the overall context of the market. While short term investors dealing in the derivatives market keep using 'beta' as a tool of analysis, the beta of a stock is of little use to a serious long term investor because *whether a stock is volatile or not is of little consequence to an owner of the business. However, an investor is more likely to chicken out from a stock that is showing too much volatility than from one which is not.* Irrespective of fundamentals it is not a great feeling to see a portfolio stock jumping up and down 5% each week for no apparent reason. Stocks that are traded in the derivatives segment generally have a higher beta when compared to stocks that are settled for delivery only in the cash market.

A beta of less than one indicates that the stock is less likely to rise or fall relative to the overall market whereas a beta of more than one is expected to indicate a higher stock volatility when compared to the overall market movement. Generally, consumer and utility stocks have low beta when compared to cyclicals and industrials while the beta of stocks that lead a bull market are generally higher because those stocks have an entire gamut of market participants trying to buy and sell them at the same time, but if a leading bull market stock has a low beta then it indicates that it still has a long way to go. The volatility of a stock or for that matter any asset class increases at turning points so whenever there is an increase in volatility or the beta of a stock that is moving upwards an investor should sit back and take note of the situation because increasing volatility is also a sign of increasing uncertainty but overall these indicators do not mean too much for the serious long term investor and are there to just act as a broad guidepost about the price movement of his stocks with respect to the market.

BOOK VALUE:

The book value of a company is the amount that becomes payable to the shareholders of a company if it is taken up for liquidation. This value remains good only for theory as in a majority of cases the actual realisable value varies significantly with the number as reflected by the book value. While land and building might realise more than the stated cost due to rise in real estate

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values the other assets like machineries and inventories do not realise as much during liquidation as is reflected in the books of account. A book value is computed as:

$$\frac{\text{Shareholders funds}}{\text{Number of Equity Shares}}$$

CAPITAL EMPLOYED:

This is defined as the amount of capital either owned or borrowed that has been engaged in the operations of a company. The capital employed does not include those investments which have no bearing to the operating business of the enterprise. A company is supposed to be efficient if it generates a higher return on its capital employed.

Shareholder funds (Equity) + Long term Debt - Miscellaneous expenditure to the extent not written off

or

Fixed Assets + Working capital

CREDITOR DAYS:

The creditor days indicates the quantum of credit a company enjoys from its suppliers. Companies that enjoy a longer period of credit from their suppliers will have a better cash flow when compared to those companies that have to pay off their suppliers quickly. Strong businesses invariably manage to get a higher credit period from their suppliers. But getting a higher credit period is not a point of strength if the company is charged extra for the higher credit period. The creditor days is computed by using the following formula.

$$\frac{365 \times \text{Closing Creditors}}{\text{Cost of Sales}}$$

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DEBT EQUITY RATIO:

The debt equity ratio is the amount of debt that a company raises for each rupee of shareholder funds. A high debt equity ratio generally indicates a higher level of risk. Debt enhances the RoE if the return on capital is more than the company's cost of capital as the company gets to make more than what it pays for. However, the company faces risks of financial failure if the return on capital is less than the cost of debt as it happens with many cyclicals when they are encountering a business slowdown.

While computing the debt to equity ratio an investor should exclude that debt which falls due over the next twelve months as such loans form a part of current liabilities. As equity increases relative to debt, the company becomes a more attractive investment. *Companies that are repaying back debt year on year experience a P/E expansion just as the P/E contracts for companies that increase debt on a sustained basis. But as a company expands in size it needs to take larger amounts of debt for its expansion program hence absolute increases in the debt levels is not that much of a concern as increase in the debt equity ratio.*

$$\frac{\text{Long term loans}}{\text{Shareholders Funds}}$$

DEBTOR DAYS:

The debtor days computes how quickly a company is able to collect its cash from its debtors. Businesses that don't suffer from competitive pressures are generally able to collect their dues faster when compared to businesses that are in cut throat competition. An investor should compare the debtor days for a few consecutive years to ensure that the company isn't booking sales by dumping goods to dealers. In some cases, an abnormal increase in debtor days leads to a situation where the company could be suspected to be booking bogus sales. While comparing debtor days an investor has to consider the seasonality of a business and as this seasonality changes the debtor days also gets affected. As the dates for Diwali and Dussehra are not constant for all the years a Diwali in early October and Dussehra in late September pulls the sales to the second quarter of the year whereas if Diwali is celebrated

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in November sales spillover to the third quarter leading to an increase in debtor days because of dealer or distributor stockings.

$$\frac{365 \times \text{Closing Debtors}}{\text{Sales}}$$

DIVIDEND YIELD:

The dividend yield of a stock is the dividend of a stock as a percentage to the current market price and supports the price in bear markets. An investor should never compute the yield on the purchase price as many investors do to increase the feel good about the stock. *Computing the yield on the purchase price is one way to remain in love with a stock that does not care who its owner is.*

$$\frac{\text{Dividend per share}}{\text{Market Price}} \times 100$$

EARNING PER SHARE (EPS):

To compute the EPS which is the profit after tax divided by the number of shares one will have to exclude the non-recurring income and expenses as adjusted for the tax payment.

While computing the EPS one should account for the weighted average number of shares for companies that have diluted equity during the period under consideration. Alternatively one can also take the number of shares outstanding on the closing date of the period under consideration. Sometimes a company might have preference shares; debentures or warrants, convertible into equity shares at the option of the holder. In that case, an investor should account for such a dilution in equity while computing the EPS to arrive at the diluted EPS.

$$\frac{\text{Net Profit - Preference Dividends (if any)}}{\text{Weighted average number of shares}}$$

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ENTERPRISE VALUE:

The ownership of a company's assets lies with its debt and equity holders. The sum total of the debt and the market value of equity shares as indicated by the market capitalisation is termed as the enterprise value of a business. For cash rich, debt free companies the market cap is reduced by the cash to arrive at the enterprise value. During bear markets a serious investor is able to locate several companies trading either at a zero or negative enterprise value. Such opportunities arise for companies whose cash on balance sheet is more than the market cap. Piramal Enterptises in 2010 and Trent in 2002 are two such examples of a stock available at negative enterprise value.

Market Capitalization + Debt

Or

Market Capitalization - Free Cash

EBIDTA OR OPERATING PROFIT MARGIN:

The operating margin is the ratio of operating profits to that of the total revenue of the company. The operating profit is defined as the earnings before interest, depreciation, tax and amortisation (EBIDTA) without including the other income component of the business. Other income is that part of a company's income which is not incidental to its core business like earning interest on bank fixed deposits or a profit from sale of land etc. Many research reports use the EBIDTA margin defined as the percentage of EBIDTA to revenues concurrently with the operating margins.

$$\frac{\text{Operating Profits}}{\text{Revenues}} \times 100$$

ENTERPRISE VALUE TO EBIDTA:

This is a crude valuation tool and gives a very broad approximation as to whether a stock is cheap or expensive. This tool is appropriate for comparing stocks within a sector and works like the P/E ratio just that the EV to EBIDTA ratio is neutral with respect to evaluating companies where one company

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is more leveraged than another. Finally, the EV to EBIDTA is not an absolute tool for valuation but helps only as a relative guide to understanding the overall valuation of an enterprise.

$$\frac{\text{Enterprise Value}}{\text{EBIDTA}}$$

FREE CASH FLOWS:

Free cash flow is the amount of cash left to a company after all its expenditure both revenue and capital has been accounted for. This is also known as the net addition to cash. While computing the free cash flow one has to make suitable adjustments for the increase or decrease in working capital as also for the non cash expense and income. In other words, it is the operating cash earnings as reduced by capital spending.

For investors who are not financially literate and unequipped in reading cash flow statements a company which does not dilute equity, has a RoE higher than revenue growth, a payout ratio of more than 25% and can keep its debt equity ratio at less than 0.5 will generally report a positive cash flow.

GROWTH RATE:

If there is one tool of valuation which supersedes all the others it is the growth rate of the company. While evaluating the growth rate an investor should focus on the long term rate of growth and hence initiate an analysis based on the compounded annual growth rate for at least the next three, five and ten years. A company that grows at 50% in one year and at 15% the next isn't as good as a company that grows at a consistent rate of 25% for each of these two years. *Markets like uninterrupted rates of growth and pays higher multiples to companies which can convince it of having the ability to achieve a consistently higher rate of growth over longer periods of time*

While the net profit determines the EPS of a company the overall sense of long term growth is obtained by looking at the revenue growth of a business. The P/E of a stock will be higher for a company that is showing both revenue and EPS growth rather than for a company that is just growing its EPS without

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a commensurate increase in revenue. This is because long term growth in profits have to be backed by growth in revenues as growing profits temporarily in the short term can be achieved only by increasing efficiency which in any case is not an everlasting tool for growth.

INVENTORY DAYS:

A company whose inventories rise at a faster clip to its sales indicates that products are being piled up and should generally be looked at in terms of a trend as to whether the inventory days are increasing decreasing or remaining the same. While computing this ratio an investor should segregate the inventories between raw material, work in progress and finished goods and evaluate the ratio individually for each of these three items. This is because its the pile up of finished goods that needs more attention than the stocking up of raw materials.

$$\frac{365 \times \text{Closing Inventory}}{\text{Cost of Goods Sold}}$$

MARKET CAPITALISATION:

The market capitalisation of a company is the amount of money that an acquirer would need if he were to purchase all the outstanding shares of the company from the market at a particular price. Young growth companies generally have small market caps whereas the old and established businesses sport a higher market cap.

$$\text{Market Price} \times \text{Number of Equity Shares}$$

INDEX P/E:

The Index P/E is the average P/E for all the stocks in the Index as skewed with their Sensex or Nifty weights. The Index P/E is inversely related to interest rates because falling interest rates are a bullish signal for the markets whereas rising interest rates are construed as a bearish sign. Interest rates generally go up when there is an overall inflationary trend and inflation with rising interest rates raises the cost of production which makes for lower corporate profits and hence lower stock prices. On the other hand, lower inflation with low interest rates increases corporate profits while positively affecting

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consumer sentiments which leads to higher profits and rising stock prices.

MARKET CAP TO SALES:

It is the number of times the sales exceeds the market cap of a company. There is no standard number for this ratio as the market cap to sales multiple is dependent upon the nature of the business and the profit margins that the business generates. *High quality growth businesses having increased profit margins generally trade at a higher market cap to sales ratio when compared to low growth businesses with smaller profit margins.*

$$\frac{\text{Market Cap}}{\text{Sales}}$$

NET PROFIT MARGIN:

The net profit margin of a company provides insight in the amount of pricing power enjoyed by the business. Companies with a higher net profit margin generally do better when compared to companies with a lower net margin. The net profit margin varies across sectors and industries for example, a pharmaceutical company would generally have a higher margin than a grocery retailer and hence comparing the two on the basis of net margin will generate misleading inferences.

$$\frac{\text{Net Profit}}{\text{Sales}} \times 100$$

OPERATING LEVERAGE:

As the company increases the scale of output its fixed costs do not increase in linear proportion to its revenues. This phenomenon of a more than proportionate increase in operating profits when compared to its revenues is termed as operating leverage.

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PAYOUT RATIO:

Payout Ratio is the percentage of profits distributed back to the shareholders as dividends. A higher payout ratio represents the free cash flow nature of the business whereas a lower ratio indicates that the company is not generating too much of surplus cash.

$$\frac{\text{Dividend per Share}}{\text{EPS}} \times 100$$

PEG RATIO:

This is the price to earnings to the earnings growth ratio. It should be less than one. A PEG ratio of one indicates that the company is fully valued whereas a ratio of more than one reflects an overvalued company.

$$\frac{\text{P/E}}{\text{Earnings Growth}}$$

PRICE TO EARNINGS RATIO (P/E):

This is one of the most widely used tools in analysing stocks. Simply put, it is how much investors are willing to pay for a rupee of the company's earnings. It is also referred to as a "multiple." When an investor calculates the P/E based on the past twelve month of earnings, the P/E is referred to as"trailing". When the P/E is computed on the basis of estimated future earnings it is known as the"forward" P/E. *Another way of looking at the P/E Is the number of years it will take to earn back the initial investment assuming that the company does not grow at all.* Check chapter 25 and 26 for a detailed discussion on the P/E Ratio

$$\frac{\text{Market price}}{\text{EPS}}$$

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PRICE TO BOOK VALUE:

This is used mainly for companies in the financial services space (where the book value after being adjusted for non performing assets) is divided with the current market price.

$$\frac{\text{Market Price}}{\text{Book Value}}$$

RETURN ON CAPITAL EMPLOYED:

Return on Capital Employed (RoCE) is the ratio of operating profit to the capital employed. In a basic sense it serves as a measure of return generated from each unit of capital deployed in the business. Commodity businesses tend to have more volatile RoCE's when compared to the more secular and stable businesses. Companies having a higher RoCE are more likely to be wealth creators when compared to businesses with a low RoCE.

$$\frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

RETURN ON EQUITY:

Return on Equity (RoE) is the ratio of the net profit to the shareholder funds and is a good indicator of the robustness of the business model. Please see chapter 17 for an elaborate discussion on the same.

$$\frac{\text{Net Profit}}{\text{Shareholders funds}} \times 100$$

STOCK SPLITS AND BONUS:

In today's environment where stocks are trading in dematerialised format the effort of reducing the average ticket price of a stock either by capitalising reserves to declare a bonus issue or by splitting the face value to issue a larger number of shares of smaller face values isn't as significant as it was

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when trading used to happen in round lots of 100 and 50 shares per transaction. Generally, a bonus or a split reduces the share price but also reduces the EPS whereas the P/E remains the same. The increase in the number of shares at a lower price keeps the investor's wealth unchanged as it keeps the company's market cap, RoE, RoCE, profitability, turnover, liquidity and solvency ratios the same as before.

Overall bonus and splits have zero impact on the financials of a company and has a feel good effect only.

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Chapter 17

GROWTH, ROE WITH DUPONT ANALYSIS

Many can forecast a company's revenue trend but the right to be rich lie with those who can forecast the stock price behaviour to that trend

The Return on Equity (RoE) is the percentage of the net profits that a company generates when compared to the average shareholder funds (also known as Equity) for that period. The RoE remains the most neglected tool of financial analysis as most investors remain caught in analysing EPS, P/E ratios, book value, dividend yields and growth rates and do not give the RoE as much attention as it genuinely deserves. An easier way of computing the RoE is to divide the EPS with the book value. This is because the net profit divided by the number of shares provides us with the EPS whereas the shareholder funds divided by the number of shares is the book value.

Money is always scarce and comes to a shareholder with the opportunity cost of being put into several alternative use on a mutually exclusive basis. The RoE of a business is therefore a simple way of understanding whether the returns from one of these alternative businesses will over longer periods of time exceed that of another. Of course, one has to consider valuations and other factors before taking an investment call but a company that is able to generate a very high RoE for longer periods of time will generally be able to create a tremendous amount of prosperity for its shareholders even if the purchase price is a little higher to start with. *Interestingly the reliance on current valuations diminish as the length of the high RoE period increases.*

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GROWING FAST AND KEEPING THE BALANCE SHEET LIGHT IS NOT EASY:

Unless the sector is passing through real pain and discomfort good companies generally manage to grow at 20% to 25% by generating a decent RoE and keeping the working capital cycle in check. A company that attempts to expand at higher rates of growth faces challenges if the overall market is sluggish and experiencing only a moderate to negative growth. Many companies try and force the pedal by trying to grow at a faster clip irrespective of where the market is going. This leads these businesses to create inefficiencies in their processes whether it relates to keeping a larger inventory or in providing higher credit facilities to their dealers and distributors, both of which would increase the capital requirement of the business and show up in the depressed RoE for the stock. A company that tries to grow too fast also creates potential problems for itself either through inventory stocking, increase in unrealised debtors or slipping product quality. Companies that outsource a major part of their production process face a greater challenge when it comes to increasing the growth rate because most of their vendors and suppliers cannot keep up pace with the company's growth rates while finding new and competent ones at short notice is always a difficult proposition.

LONG TERM GROWTH IS A FUNCTION OF ROE AND DIVIDEND:

Theoretically, a company would find it impossible to grow beyond the RoE and in case of a dividend paying company the quantum of growth is limited to the extent of the retention ratio as multiplied with the RoE. Retention ratio is that percentage of the profit which is not distributed as dividends so a company that pays 30% of its profits as dividend will have a retention ratio of 70%. The growth rate of a company under a steady state of business can thus be computed by the following formula:

$$\text{Growth Rate} = \text{RoE}\ (1\text{-payout ratio})$$

This formula assumes that the company incurs the same level of costs while continuing to operate with the same level of efficiency and hence represents just a tendency and is not a foolproof method for forecasting the actual growth of the company.

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The expression above also represents the dividend growth tradeoff that companies normally tend to make. As dividend acts as a gravity on growth a higher payout ratio theoretically results in a lower growth whereas to grow at a faster pace companies have to retain and deploy back a large part of their earnings indicating that in theory, a company that pays out all that it earns will grow at zero percent.

Businesses like the FMCG companies that need and employ very little capital generate a high RoE whereas businesses like steel, cement, power etc that need and employ a lot of capital generate only a moderate RoE. *The real home run is hit in a company that can employ a lot of capital and also generate a high RoE. The scale of opportunity in such a business should be several times the company's revenue.* An investor who can identify a business that generates a high RoE and is scalable has found an investment jackpot. No wonder Titan's stock appreciated more than 150 times since 2002. 'Tanishq' the jewellery business of Titan was one such business where scalability wasn't an issue and with the high return ratios the company could put large amounts of capital to work. However, the subsequent regulatory changes that affected the gold on lease scheme has to a very large extent, destroyed the uniqueness of the business model.

DIFFICULT TO GROW BEYOND THE ROE:

A company that generates an above average return on equity does not suffer from shareholder pressure to declare dividends and can therefore keep growing at rates closer to its return on equity. But if a business wants to grow at rates higher than the RoE (1 - payout ratio) it can do so only by increasing operating efficiency, issuing new shares or by taking on further debt.

During a bull market, many companies find ways to grow at more than their RoE. However, such growth is temporary and generally does not extend beyond three to five years which in many cases is the length of the bull cycle. A few years of growth funded by repeated share issues and borrowings creates roadblocks for further growth. This is because the balance sheet of these fast growing companies gets bloated through repeated fund raising efforts. A company that grows too fast also engages in gross mis-allocation of capital and as the bull market subsides the mantra for these high fliers

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change from 'growth' to 'survival'. *A business will generally find it difficult to grow at more then one and a half to two times the sector growth so if the sector is growing at 15%, the best company in that sector will face roadblocks growing at more than 30%.*

HIGH ROE WITH LOW GROWTH:

If the company encounters a growth headwind after it has exhausted all options to increase scale and size then in spite of having a high RoE the gains to its shareholders will be limited only to the extent of the nominal growth and the yield of the stock. Most high RoE companies start to increase their payout ratio after they realise that the high growth rates of the past cannot be carried out in the future. Though this strategy keeps the stock from falling down, the slowing growth also acts as a gravity on the stock price and restrains it from going up.

Having a high RoE is just one aspect of the analysis and the other and more important factor to look out for is the availability of growth opportunities and the ability of the company to increase its scale and size to capture such an opportunity. Good companies are therefore always on the lookout for new markets, new distribution, new products with innovation to the existing product lines just to keep their growth rate extended and intact.

TAKING DEBT TO GROW BEYOND THE ROE:

As indicated above the process of issuing shares and raising debt cannot continue forever. Consider a company Super Fast Ltd that intends to grow at more than its RoE:

From the following table, Super Fast Ltd had shareholder funds (share capital + reserves) of ₹200 crores in year 1 on which the company generated a RoE of 40%. The net profit on this 40% RoE comes to ₹80 crores whereas with a 25% payout ratio the dividend works out to ₹20 crores. The sustainable growth assuming no change in efficiency works out to RoE (1-payout ratio) which is 40% x (1-25%) = 30%.

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FINANCIALS OF SUPER FAST LTD A COMPANY THAT INTENDS TO INCREASE GROWTH BEYOND WHAT THE ROE PERMITS

	Year 1	Year 2	Year 3
Shareholders Funds	200	260	338
Debt	0	0	?
Targeted Growth		30%	40%
Net Profit (Shareholder Funds x RoE)	80	104	145.6
Dividend Payout @25%	20	26	36.4
Retained Earnings	60	78	111.3
RoE	40%	40%	?
RoE (1-Payout Ratio)	30%	30%	?

(figures in ₹ crores)

For year 2, the shareholders funds (share capital + reserves) at ₹260 crores has been added by the ₹60 crore retained earnings of year 1. On this ₹260 crore shareholder funds the company generates a RoE of 40% and makes a profit of ₹104 crores which is a 30% increase over the previous year's profit of ₹80 crores. On a 25% payout ratio the dividend amounts to ₹26 crores. The growth in net profit at 30% is exactly equal to the RoE as reduced by the payout ratio which is the sustainable growth assuming no change in efficiency.

Now in year 3, the management expresses a desire to grow its profits by 40% instead of the 30% that it was growing at for year 1 and year 2. So on a net profit of ₹104 crores in the previous year it would need to grow profits to ₹145.6 crores which is a 40% increase over the previous year's profit.

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But the normalised RoE of 40% on its existing shareholders funds of ₹338 crores can generate a profit of ₹135.2 crores only, leaving a gap of (145.6-135.2) ₹10.4 crores.

It is assumed that the business also generates a return on capital employed that equals the return on equity of 40% but the key point to identify is the amount of debt that the company would need to raise to generate a profit after tax of ₹10.4 crores. Assuming a 12% cost of debt and a tax benefit of 30% as interest payments qualify for expenses deductible for computing the tax liability, the cost of debt works out to 12% - (30% of 12%) = 8.4%. As the RoCE and the RoE is 40% the net addition to the profit will be 40% - 8.4% = 31.6% of the funds. Therefore, to generate a profit of ₹10.4 crores at an incremental rate of return of 31.6% the company would need to borrow ₹10.4 crores divided by 31.6% = ₹32.91 crores.

The company could also issue shares to meet up to this shortfall and in that case one will have to approach the question in the same format to work out the number of shares to be issued keeping the current price of the stock in mind but issuing more shares will affect the EPS of the company which will not grow at the same rate as the growth in profits so one will have to work out the numbers keeping that in mind



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THE DUPONT ANALYSIS:

The general equation for computing the RoE as indicated above is to divide the net profit with the shareholders funds. However the complete RoE expression can be broken down as:

Net Profit Margin x Asset Turnover ratio x Leverage

where:

Equity = Shareholders Funds

Net Profit Margin = Net Profit/Sales

Asset Turnover ratio = Sales/Assets

Leverage = Assets/Equity

= Net Profit/Sales x Sales/Assets x Assets/Equity

= Net Profit/~~Sales~~ x ~~Sales~~/~~Assets~~ x ~~Assets~~/Equity

= Net Profit/Equity

Individually each of these ratios indicates how well a company is managing its expenses, assets and debt. During the 1920's the DuPont Company of USA further decomposed the RoE to formulate an analytical tool which is now referred to as the DuPont analysis. Here the net profit margin was further broken down into three parts:

a) PBIT Margin = PBIT/ Sales

b) Interest Burden = PBT/ PBIT

c) Tax Burden = PAT/ PBT

where:

PBIT = Profit before interest and tax

PBT = Profit before Tax

PAT = Profit after Tax

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THUS THE NET PROFIT MARGIN COULD BE EXPRESSED AS :

= PBIT/ Sales x PBT/ PBIT x PAT/ PBT

= PAT/ Sales or Net Profit/ Sales

WHILE THE RoE CAN BE EXHAUSTIVELY EXPRESSED AS:

Operating Margin × Interest Burden × Tax Burden × Asset Turnover × Financial Leverage

= ~~PBIT~~/ ~~Sales~~ x ~~PBT~~/ ~~PBIT~~ x PAT/ ~~PBT~~ x ~~Sales~~/~~Asset~~ x ~~Assets~~/Equity

= PAT/Equity

Another way of expressing the RoE is by multiplying the 'return on assets' with the 'leverage'. While decomposing the RoE it is essential to analyse the quantum of RoE magnification achieved from the use of leverage. A company that increases its RoE by excessive use of leverage isn't as good, as a company that generates a high RoE with minimum use of leverage. In some cases, a company generating a high RoE from too much leverage puts itself in a worse off situation than it would have had it not used this excessive leverage.

To understand the leverage factor in the RoE an investor should break the RoE on the basis of Return on Assets and Financial Leverage.

= RoA x Financial Leverage

= Profit After Tax (PAT)/~~Assets~~ x ~~Assets~~/Equity

= PAT/Equity

HOW CAN COMPANIES INCREASE THE RoE?

A company has three ways of improving the RoE. It can increase operating profit margins by raising prices or controlling expenses, increase asset turnover by increasing the productivity of assets or by outsourcing its manufacturing processes which makes the company asset light as the capital expenditure is borne by the vendor and finally RoE can be increased if the company takes more leverage (debt). However, financial leverage will work only if the return on capital is continuously more than the cost of capital.

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Most asset heavy industries like infrastructure, construction and cyclical businesses get adversely impacted during the downcycle when they leverage beyond the point that they can comfortably handle. This is because a business slowdown leads to a lower return on capital and as this ratio falls below the cost of capital the business starts moving towards serious financial distress.

The DuPont model is an exhaustive tool which captures almost all the activities of a business. Any decision relating to pricing of the products, changes in costs, volume and productivity affects the net profit margin or the asset turnover ratio. Likewise any increase in debt or equity affects the leverage ratios and hence impacts the RoE.

Generally, the RoE in its decomposed form, growth rate and dividend payout provides the maximum amount of information on how a company is slated to perform over longer periods of time. *An investor who buys into a business even at a high valuation will stand to make a lot of money if a business can maintain its high RoE for longer periods of time.*

WHERE IS THE RoE RELEVANT AND WHERE IS IT NOT?

Computation of RoE as a tool of analysis is not relevant for businesses that are cyclical in nature and whose cost structure is subject to wide swings because of changes in the underlying input prices.

Another types of companies where the RoE will have little application are holding companies and asset plays, companies that hold valuable assets either in terms of a land, bank or in terms of cash on balance sheet. These companies are generally asset heavy and will show up a depressed RoE number due to the presence of assets that don't contribute too much to earnings.

NET PROFIT MARGIN IS JUST ONE PART OF THE STORY:

Most analysts and investors focus on the net profit margin of a company and look at it in isolation rather than understanding it under the DuPont framework. Sometimes an investor spends too much time analysing a stock from just one perspective, for example an investor in a stock might not like

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the low margin nature of a business but a company in a low margin business might be using a relatively lower amount of assets and hence generating a high RoE. In this connection, a retail jewellery chain or a construction company that generates lower margin but has a high asset turnover ratio by employing little capital and turning its inventory faster might have a relatively higher RoE when compared to a TV broadcaster whose high margin with a lower asset turnover ratio normalises the RoE of the business.

Similarly, a company selling high end fashion garments might have a very high margin but would have tied up a substantial part of its capital in fixed assets, inventories and receivables so its asset turnover might not be as high as a toothpaste manufacturer that buys raw material on credit and sells on cash while getting its raw material converted to finished products by third party suppliers. *It is therefore imperative that an investor analyses all the aspects of a RoE rather than look at just the net profit margin as most stock analysts tend to do as having a low net profit margin and a high asset turnover is as good as having a high net profit margin and a low asset turnover.*

A OVERVALUED HIGH GROWTH STOCK IS BETTER THAN AN UNDERVALUED LOW GROWTH ONE:

Overall the RoE functions as one of the most decisive drivers of growth and as markets pay for growth most of the secular high growth companies consistently generate a very high RoE with a small payout ratio. Now consider the following table:

In this example Super Fast 30% Ltd is a high RoE company which grows at 30% CAGR for ten years and is available at a current valuation of 40 times trailing while Slow & Steady 18% Ltd is a moderate RoE business available at 20 times trailing and is expected to grow at 18% over the same period.

	SUPER FAST 30% LTD			SLOW & STEADY 18% LTD		
	EPS	P/E Ratio	Price	EPS	P/E Ratio	Price
Year 1	10	40	400	10	20	200
Year 2	13	40	520	11.8	20	236
.....						
Year 10	137.9	25	3447	52.3	20	1046
Price CAGR			24%			18%

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If the growth hypothesis is not violated and an investor is sure about the growth prospects of the business then the company with higher growth outperforms its cheaper low growth peer even while it is assumed that the P/E ratio of the high growth company will be cut to 25 at the end of the ten year period, it is thus more profitable to back up an over priced growth stock with a high RoE assuming that the growth story remains intact and more often the business model along with the industry environment will provide the best forecast on the long term sustainability of growth.

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“It is better to buy a mediocre company with strong economic tailwinds than to buy a great business facing strong headwinds.”

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WHEN DOES AN ACQUISITION WORK OUT & WHEN IT DOESN'T?

In the corporate world the shikar (acquired company) is more valuable than the shikari (acquirer).

When companies grow in size they face challenges in meeting up to their past growth rates. This inability in keeping up to the momentum of the past encourages these companies to acquire new businesses either in cash or through issue of shares. Though a majority of acquisitions are made to extend the dwindling growth trajectory of an ageing business in some cases an acquisition or a merger is done to improve the competitive dynamics of the industry in which the acquirer operates. Most of the cement deals in India happened with this mindset because setting up a cement plant came with the risk of creating further supplies whereas buying out an existing unit increased the capacity of the acquirer without affecting the overall demand supply equation.

In some cases when a fast growing business moves to acquire other assets in its industry the signal to the stock market for an era of moderately slow growth ahead is clear and apparent. This is so because acquisitions and mergers are one way to artificially extend the days of rapid growth of a company so as to retain the stock price momentum or fulfil the management's desire to become larger in size and be noticed on the corporate map.

Generally, an acquisition of commoditised businesses by companies having a negative operating cash flow and without entry barriers, through debt nearer to the top of the business cycle is an indication of potential financial distress.

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THE MINORITY INVESTOR:

The minority shareholder of the company being acquired benefits more than the shareholder of the company making the acquisition. If given a chance an investor should ideally buy shares of the company that is being acquired rather than go with the one that is making the acquisition. This is because all negotiated deals generally happen at rates that are above fair value.

In the Indian context there are plenty of foreign MNCs that keep acquiring shares from the minority shareholders by paying hefty premium to the prevailing market price. Though this is not a takeover in the real sense this acquisition of minority shares by the majority owners to increase their holding provides an investor with a small arbitrage opportunity after the open offer has been announced. On the other hand, the opportunity cost of buying a prospective company with the hope that it would be bought out some day is just too high as these deals seem clear in hindsight but come with undefined timelines in foresight. But if an investor were already holding the stock it makes sense to sell it at a slight discount in the open market rather than give it back to the company as shares tendered back to the company do not qualify for exemption from long term capital gains tax.

THE RETURN ON INVESTED CAPITAL TEST:

The variance in view between the majority* and minority shareholders is significant when it comes to understanding the management's acquisition strategy.

While the majority owners may have a ten year view the minority view can run for just a few quarters. Unlike the minority investor who has the option of selling a stock and buying another one from the same or a different sector the promoter of a company who is generally the majority owner does not have any such options. Additionally, the opportunity cost of cash for the majority owner of a company is the pre-tax bank fixed deposit rate of interest

*The term majority also refers to the largest owner of shares and includes the promoter or the management or anyone who exercises control over the company by whatever name called.

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and the business would do fine if the company were to use this cash to generate a return in excess of this opportunity cost of capital.

One tool for evaluating the economic viability of an acquisition is to compute the Return on Invested Capital (RoIC). A management that is getting a pre-tax 8% yield from a bank fixed deposit will find a deal that provides a 9% pre-tax yield as EPS accretive but if this deal is diluting the overall return on capital employed (which it would if the RoIC of the existing business was higher when compared to the new business being acquired) then the logic for making the acquisition gets diluted even if it is EPS accretive. The RoCE gets diluted because cash held under investments do not form a part of the capital employed whereas if this cash is used up in buying a new business it would form a part of business investment and therefore be included in the computation of capital employed.

For the purpose of computing the RoIC the capital employed of the business being acquired is immaterial, what is relevant is the amount it is being taken over at. A company buying out another company with a capital employed of ₹25 crores for a purchase consideration of ₹35 crores will compute its RoIC at ₹35 crores and not at ₹25 crores. The difference in value of ₹10 crores is the goodwill that will be written off over a period of time in which the acquired assets are assumed to last. This write off creates a profitability overhang on the company till the time this goodwill is completely written off.

As acquisitions are identified, advised and managed by investment bankers against a fee, it makes sense for these advisors to present a positive thesis on the same. The focus remains on the justification of the deal rather than on the verification of the same. A bad acquisition has the power to cause considerable wealth destruction for the acquiring company as the recent market history is littered with examples of how acquisition hungry companies moved into a position of financial distress after acquiring expensive businesses both in India and abroad.

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INDIAN CEMENT INDUSTRY:

The Indian cement industry has been consolidating for the past decade as most cement stocks have failed to deliver above average returns to their shareholders. Within this industry Shree Cement has stayed away from the acquisition game and instead focused on setting up incremental capacity on its own, through internally generated resources even while the other companies in the sector have participated either in the merger and acquisition game or by diversifying into unrelated fields of activity like the India Cements foray into owning a cricket franchise in 'Chennai Super kings'. Meanwhile, the shares of Shree Cement has moved up 100 times in the last ten years which is far ahead of any other company in the entire basic industries segment. Shree Cement remains one of those rare examples where the promoter has managed its ambition by scaling up business in a slow and steady manner rather than trying to bite off more than it can chew. The company has also defied the logic though only as an exception that a cyclical company cannot create long term wealth for its shareholders.

BHARTI AIRTEL:

Bharti Airtel moved into Africa after its domestic business started showing signs of saturation and the purchase of the African telecom company Zain for $10.7 billion was made to extend its faltering growth. After acquiring Zain, Bharti embarked on a program to re-brand its African business spread over 16 countries with a view to increase penetration and expand market share. However, the profitability of Zain did not justify the acquisition amount as it slipped immediately after the takeover which just proves how most acquisitions are dressed up for growth.

SUZLON:

In Suzlon's case the acquisition of Hansen Transmission International of Belgium in 2006 for around ₹2,500 crores appeared as a strategic fit as Hanseen was a leading gear manufacturer for wind turbines. A couple of years later Suzlon attempted to take controlling interest in REpower Systems, a leading wind turbine manufacturer from Germany, having a strategic

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geographical presence with a related product portfolio. The buyout was also supposed to benefit Suzlon by providing synergies in supply chain management. However, the acquisition undertaken in three separate deals valued for ₹10,500 crores was aggravated in a bidding war with Areva which increased the cash outlay for the Indian wind-power company.

Even though Suzlon had a majority holding, German laws restricted it from merging the cash rich RePower with itself as a result of which Suzlon continued to struggle with debt on balance sheet even though its 100% subsidiary was flush with cash. Meanwhile, the Indian government removed tax incentives for accelerated depreciation on wind power generation which led to a slump in the domestic business of the parent company. As the company grappled with its multiple level crises the stock price started rolling downhill and collapsed more than 98% to ₹6 by November 2013 from its stratospheric highs of around ₹460 in 2007.

Had Suzlon not extended itself in its acquisition strategy it would have faced the industry downturn like all other businesses and then hopefully come out of it. *Over time an overly ambitious management which bases its strategies on size and scale instead of focusing on the return on investments of the new ventures finds new ways to destroy old things.*

A company faces challenges when it tries to acquire expensive assets in the developed world as the markets there are more saturated when compared to the home country of the acquirer. Moreover, the cost of operations in the developed economies are higher and there is always an issue of human resource mix that employees of the parent company face with those of the target company both in terms of operational responsibilities and compensation packages.

PUNJ LLOYD:

Punj Lloyd was another fast growing company that got trapped in the acquisition game. For the six years starting from 2004, Punj had increased revenues by 6.6 times or at an annualised rate of 37% funding its growth through a mix of debt and shares issues. The company acquired a 100% stake in the Singapore based Sembawang Engineers & Constructors for around

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Singapore $38.3 million and tried using Sembawang's UK subsidiary 'Simon Carves' for getting a foothold in the UK market. However, the UK business suffered due to a lack of escalation clause as even though input costs continued to rise worker productivity remained significantly short in contrast to the wages that was being paid to them. The loss making business of Simon Carves led to a large blowup of the parent company's cash and even while this money was raised on the balance sheet of Punj Lloyd the losses ensured that the debt on balance sheet stayed on the books without any corresponding assets. Tagged as the next Larsen and Toubro the stock price of Punj Lloyd fell 95% from its January 2007 high of ₹580.

TATA STEEL:

In 2007, Tata Steel acquired the Europe based steel company Corus, for $12.1 billion in a move that was strategised at exporting the low cost steel slabs from India to the high end finishing plants of Corus abroad. The acquisition was expected to give Tata Steel a foothold in the European markets and with an annual capacity of 25 million tons would make it the fifth largest steel producer in the world. Tata Steel had earlier bought over Nat Steel in Singapore and a 67% stake in Millennium Steel of Thailand. These small acquisitions had given the company enough confidence to pick up a larger company. At the time of the Corus takeover, the global steel industry was in a boom with the European and U.S economies doing reasonably well while demand for commodities was on an upswing buoyed by the Chinese preparations for the 2008 Beijing Olympics.

The Corus buyout started a bidding war with the Brazilian major CSN. Corporate takeover economics which are worked out at a price are ultimately inflated by ego, where the near term economic sense is substituted for scale, size and the desire to be noticed on the global map. As this bidding war escalated, it inflated the final figure by 34% to the initial bid.

Tata Steel's hostile takeover of Corus was also influenced by Lakshmi Mittal's $34 billion acquisition of Arcelor in 2006, which made Arcelor-Mittal the largest steel producer in the world. The fear of being left out in the global steel industry compelled the Tatas to take this big leap forward even though being a low cost producer matters more than being the number one company

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in a sector which is thoroughly commoditised. While Laxmi Mittal built his steel empire buying cheap assets across geographies especially from emerging economies such as the erstwhile Soviet Union and Mexico, the Tatas were paying top dollar for Corus. Moreover, Laxmi Mittal configured his Arcelor buyout in both cash and stock whereas the Tata Corus deal was primarily a cash buyout deal. Additionally, Mittal's bid for Arcelor at an EV to EBIDTA of 6.2 compared quite favourably to Tata Steel's purchase of Corus at an EV to EBIDTA of almost 9 times.

The U.S sub prime crisis surfaced immediately after Tata Steel finalised its plan to buy out Corus and with the collapse of Bear Sterns and later Lehman Brothers, a major part of the developed world went into deep recession. Subsequently, buyers of steel from segments such as automobile, housing and construction were fighting for survival while the Chinese slowdown was affecting the multi year commodity bull run and as metal prices collapsed, the entire manufacturing sector was pushed into a slowdown. The boom in the steel industry had been a result of increasing iron-ore prices which was benefitting mostly those steel companies that had access to captive iron ore mines. Without a strong raw material linkage and a high cost structure, Corus was now a drag on the fifth largest steel producer in the world.

HINDALCO, TATA GLOBAL, GMR & THE OTHERS:

The boom in global markets prior to the big slump in 2008, influenced several Indian companies in their quest for acquiring foreign assets. Hindalco, a Aditya Birla group company also struggled with its acquisition of Novelis, in 2007 as on a buyout price of $6.2 billion the return on capital fails to hit the 10% mark even after six years of investment.

A few more acquisitions that have not worked out well for the acquirer have been Tata Global Beverage's acquisition of Tetley, UK as even after a decade of operations the price paid cannot be justified In terms of RoCE. GMR Infrastructure also struggled on its $1.1 billion investment in the American power company, 'Intergen'. Crompton Greaves, has been struggling to put its acquisition of several European and U.S firms in order and Havells buyout of Sylvania also did not work out as desired.

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WHY ACQUISITIONS FAIL?

Most Indian acquisitions abroad have been made for cash at nearer to peak valuations. Tata Steel was one of the best steel producing companies in India till it went ahead and bought Corus in Europe. Steel as a business is based out of raw material linkages which Corus had little access to and in the next downcycle the bleeding European business took a toll on Tata Steel's balance sheet. Generally, acquisitions of cyclical businesses happen on leverage when the cycle is in full swing. This is because at that time the acquirer is flush with cash and low on debt. Alternatively, during times of recession the acquirer is in financial constraint and faced with its own problems of leverage which makes it difficult for it to expand and further leverage its balance sheet for making cash based acquisitions.

A cyclical company should be acquired through share swaps which is an instrument of payment where the shareholders of the acquired company are paid by issue of fresh shares of the acquiring company rather than in cash. If the acquisition is being done in boom conditions the issue of expensive equity by the acquirer will offset the cost of the expensively acquired assets. However, shareholders of a company being acquired internationally prefer cash and are reluctant to receiving stock compensation of a company from an emerging nation. To overcome this drawback many Indian companies have got themselves listed on the international exchanges so that if an acquisition is done in the future they have the necessary stock currency to pay it through. On the other hand, an acquisition made with debt as an obligation to future cash flows have the potential to disturb the financial setup of the acquirer if an industry downturn arrives soon after the acquisition has been made as it happened with the Tatas after the Corus deal.

TATA MOTORS JLR:

Prior to the 2008 crisis, Tata Motors bought out the British automobile maker Jaguar LandRover (JLR) for $2.3 billion from Ford Motor Company as part of its desire to diversify away from the domestic commercial vehicle business. This buyout was followed by the subprime crisis which put JLR under serious threats of survival. But in this case, the depreciation of the British Pound post

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2008 came as a shot in the arm for JLR as products manufactured from the UK based plants became competitive in the export market. Under the new Tata management JLR launched multiple new products including the Range Rover Evoque a product that sold very well in emerging markets especially China and over the next five years the contribution of JLR to the overall profitability of Tata Motors moved in excess of 90%.

EMAMI ZANDU:

Sometimes a consumer company having a large dealer, distributor network acquires an under penetrated consumer brand to leverage the acquired asset through its own distribution network. Emami's acquisition of Zandu Pharma was made with the intention of increasing the reach of Zandu through Emami's distribution network and five years into the acquisition Emami should have nothing to complain about the deal. All that an FMCG company needs is a good product with a good distribution. After this, everything else happens on its own. It takes years of effort for a company to seed its product through the various parts of the country and over a period of time, a company that succeeds in increasing its distribution reach through deeper and denser penetration emerges as a clear winner. So if the acquiring company has a better reach than the company which is being acquired, revenue growth can happen almost overnight.

Godrej Consumer is another acquisition hungry consumer company which uses its excess cash to buy up niche brands. Generally, acquisition of niche consumer brands isn't such a negative thing because most consumer companies generate free cash flows with high RoCE which helps them service the cost of acquisition quite easily.

ALL ACQUISITIONS ARE NOT BAD:

All acquisitions are not bad as acquisitions which extend the product line of an enterprise in businesses having entry barriers with pricing power has a lesser chance of failure than the cyclical buyouts. Companies with entry barriers and pricing power are mostly secular growth businesses whose chance of encountering a cyclical downturn remains remote immediately after the buyout. An Emami with a Zandu or a Tata Motors with a Jaguar

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LandRover are examples of acquisitions of businesses with entry barriers which ultimately benefitted the acquiring company.

Pharmaceutical companies benefit from an acquisition the most as the takeover brings synergies in the research and development work by removing the duplicities which lead to a large savings in cost. Sun Pharmaceutical is another company that keeps growing through the acquisition route. In the case of Sun's takeover of Taro the company immediately raised the price of the products of the acquired company thus justifying the premium it paid for the acquisition.

Overall a large acquisition for debt, by a company having little product differentiation has had a history of being returns dilutive for the existing minority shareholders. On the other hand, the benefits have been more pronounced when the acquisition is for a product with some sort of a pricing power. Tata Motors with JLR; Emami with Zandu, Sun Pharma with Taro are examples of an acquisition that did well. The real trick to making an acquisition of a commodity cyclical business is to buy the same when the entire industry is passing through pain and not when everybody is in gain as was done by both Laxmi Mittal and Anil Agarwal of Vedanta. *Otherwise an acquisition generally leads to a disappointment for the minority shareholders because it is always cheaper to set up a capacity than to buy it out from the seller at his price.* But the economics swing *if the acquisition is for a niche brand because it is more challenging to build a brand than to set up a factory but like all investing decisions the economic benefit of an acquisition is solely dependent on the price that the acquirer pays for the assets on sale.*

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Chapter 19

IS YOUR COMPANY TAKING UP MARKET SHARE?

Investing is about making less and retaining more rather than making more and retaining less.

The primary indicator of a company's strength is the ability of its management to engage itself in a continuous and relentless market share capture. An easy *way of identifying whether a company is capturing market share is to look for a business whose revenue growth is more than that of its competitor and also in excess of the rate at which the entire market is expanding.* If a company isn't growing as fast as its competitors even while the growth is higher than the rate at which the market is expanding its gain in market share would be less than that of its competitor. For instance, a company growing at 20% when the market is expanding by 15% will be said to have done better than another company growing at 20% when the market is expanding at 15% while its competitor is growing at 25%. While both companies are gaining market shares the latter is losing out to its competitor in the game of market share capture.

The annual report, management conference calls and other company presentations will carry the management's view on the changing market dynamics. A check for gain in market share capture should also be evaluated keeping the profitability of the venture in mind. *A company that gains market share by lowering prices, excessive advertising, higher dealer discounts or by engaging in loss leader pricing isn't as good as a company which gains market share in the ordinary course of business.*

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MARKET SHARE GAINS WITH ROE:

Companies that are growing too fast come with their own drawbacks of capital misallocation and in the bid to expand rapidly create inefficiencies within their processes and systems. The rapid expansion has to be thus evaluated in the backdrop of its impact on the RoE. *A company that is gaining market share by diluting its RoE will face challenges in creating long term shareholder gains when compared to a business that is gaining market share by retaining its high RoE.* Most companies dismiss the diluting RoE argument with reasons that a growing company needs to invest into the future and that such an investment will bear fruits over the long term. Irrespective of such arguments, a truly outstanding company capable of generating above average shareholder wealth for longer periods of time will always find ways to retain its high RoE focus. But, if there is a scorching bull market in vogue and the leading stock of the bull market sector is growing fast by diluting the RoE then the effect on the price of the stock will come with only a lag effect. Pantaloon Retail was one such stock that was engaged in mindless capture of the consumer's spending pie as from a lifestyle and fashion retailer the company diversified into groceries, home furnishing, office supplies, insurance, asset management, consumer finance and even real estate management. Their unrelated diversification into different businesses during the 2003 to 2008 bull run hit them hard later on. Burdened by their inability to manage growth the stock fell 90% from its all time high price of January 2008 as the RoE at 20% was never enough to justify the lofty valuations and the mindless expansion plans of the company.

Similarly, the large construction companies like Larsen & Toubro and Nagarjuna Construction Ltd have swapped their business model of providing construction services for asset ownership. In order to maintain their high revenue growth most of the construction companies which were earlier doing road and other infrastructure projects as service providers started to set up projects under the Build Operate and Transfer (BOT) schemes by owning road and other infrastructure assets on their balance sheet. This transformation of a service provider to an asset owner was necessary for the company to get an uninterrupted flow of work to maintain its growth momentum. As the company started to book orders from its own BOT projects it did so while compromising on its quality of earnings by diluting RoE which led to a compression in valuation ratios.

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BETTER TO WITHDRAW THAN UNDERCUT:

In case of companies engaged in the business of financial services like banks and Non Banking Finance companies (NBFCs), an investor should avoid companies that are mindlessly chasing market share. In 2008-09, Gruh Finance a rural housing financier and a subsidiary of the mortgage leader HDFC saw tough competition from ICICI Bank and IndiaBulls when these two competitors attacked Gruh's rural home mortgage market with low interest rate loans. This made the management at Gruh to temporarily withdraw from the market instead of lending at rates that were devoid of any economic sense. In a couple of years, ICICI and IndiaBulls retraced from the market while Gruh was back to its old ways of lending. While IndiaBulls continues to struggle and ICICI is still below its 2008 high, Gruh has moved up seven times from its January 2008 peak price.

SMALL AND NICHE PRODUCTS:

If the overall market size is small with one player controlling a large part of the market then the small size of the market coupled with a dominant sector leader will put off any competition from entering the market. Zydus Wellness the manufacturer of 'Sugarfree' controls close to 90% of the ₹200 crore low calorie sweetener market. The brand has grown 100 times in the last 20 years and has not found any serious competition till now. Small niche markets with a dominant brand will act as natural barriers to entry as larger players would not be interested to get into such a market while the smaller ones would not have the power to spend ₹100 crore on advertising to capture such a small market. Over time, the leader of this small market becomes large in size as it achieves economies of scale. Pidilite's adhesive brand 'Fevicol' is another example where the company did not face any aggressive competition as it grew from small to large by independently expanding the market over the last few decades even while retaining its overall market dominance.

TWO PLAYER MARKET:

Shareholders make reasonable gains in a two player duopoly market. A two player market generally sees little competition even while one player takes up market share for a while before the other one returns back to regain lost

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ground. The Indian two wheeler market till very recently was a classic example of this where Hero MotoCorp and Bajaj Auto lost and gained market share to and from each other over small periods of time but even though competition was tough between these two dominant players they did not let a third party dominate the market. The battery manufacturers like Exide and Amara Raja and the cooker companies like Hawkins and TTK Prestige are also examples of a two player market. *Irrespective of temporary slippages companies in a two player market generally do very well for their shareholders over longer periods of time.*

The battle for toothpastes between Hindustan Unilver and Colgate in the 1990's is a good example of a two player fight. While Colgate continued to grow its market in the 1980's the growth in Hindustan Unilever's 'Pepsodent' came in to challenge the same in the mid 90's from where the toothpaste market became a two cornered contest.

Another example of market share capture is Amara Raja vs. Exide. From 2009, Amara Raja continued to eat into Exide's market share as it increased revenues at a CAGR of around 22% compared to a 12.8% CAGR in revenues for Exide. While Exide continued to struggle with its profitability by growing it to less than a double in this period, the profit growth in Amara Raja was more profound as it grew profits by three and a half times. The two stocks have respectively returned three and twenty times respectively between March 2009 and November 2013.

For a lay investor, who spends only four hours a week tracking stocks all he had to do was check for quarterly revenue growth amongst the various companies in a sector. More often it will be the number two company in a sector which will challenge the number one. An Exide shareholder did not need any more proof than to see Amara Raja showing higher revenue growth for the entire period between 2009 to 2013 to understand that his house is on fire.

The main issue that holds the investor back in such a situation is the ownership bias of holding a stock. In this case, an Exide shareholder will try and research more to confirm that the loss in market share to Amara Raja is just temporary

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and it well might be. If the gap between the number one and number two is very large then one can ignore these short term variations but if the two leading players are running neck to neck then it does not take long for a new trend to develop. *Ownership bias of holding the stock will force an investor to argue that the growth differential is temporary and is set for a reversal.* There are no easy answers here but I faced the same issue when I was holding Hawkins vis-a-vis a TTK Prestige. Hawkins was dogged by problems like fighting a battle with the pollution department in Punjab and labour problems in its Uttar Pradesh plant but since the problems were temporary and reversible I decided to hold on and in fact bought a few more even as the price slipped 40% from ₹2,100 to below ₹1,300 in a matter of a few months. The strategy for staying with Hawkins was initiated because I was already an owner of the stock but had I been holding TTK I am not sure if I would have thought the same about Hawkins as I did while holding the stock.

MARKET SHARE THROUGH ADVERTISING:

Looking for advertising spend as a percentage of sales isn't a one size fits all strategy. A brand in a nascent stage with a ₹5 crores turnover might have to do a 200% advertising spend on its revenues to create awareness whereas another established brand with revenues of ₹1,000 crores might just have advertising budget of 5% of its revenues to retain the market. When a product is small and significantly under-penetrated, word of mouth does not work as much as it would once the product achieves a certain degree of critical mass and traction. This is because spreading awareness through word of mouth is a function of geometric progression where starting from a low initial base will take that much longer for a company to reach out to all the constituents of its target market than what it would, if the initial base was slightly higher.

LARGE COMPANIES GAIN MARKET SHARE IN TIMES OF RISING COSTS OF INPUT:

In times of an inflationary environment most businesses suffer from rising input costs the first impact of which is to increase the working capital requirement of the business. Under such a scenario the small and marginal

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firms find it difficult to mobilise the incremental funds to meet up to their new and enhanced working capital requirements. Due to the non-availability of requisite funds most of the smaller firms have to be contended with a lower volume growth than what they would have managed under a stable cost environment. The larger firms however, have no such fund raising compulsions and use this opportunity to gain market share from their smaller and weaker competitors. The temporary shortage and the reduced competition also makes it easier for the industry to pass through the enhanced input costs to the consumer.

LEADER WITH A DOMINANT MARKET SHARE GAINS WITH NEW COMPETITION:

One thing interesting about market share capture is that if a new competitor enters a market with a dominant player, his first round of advertising creates demand for the existing player. That is, if Marico increases advertising spend for almond hair oil, a market dominated by Bajaj Corp then the first effect of that advertisement spend will be an increase in sales of Bajaj Corp. The leader is always the first to gain when the new competitor spreads product awareness of an existing product. This is because the distribution strength of the leader is more equipped to handle the new thrust of demand that arises from the product awareness program of the competitor. The shopkeepers and distributors are also more than ready to push the existing product than to make the customer experiment on a newly introduced item from the competition.

ORGANISED VS. UNORGANISED:

In a market structure dominated by both the organised and the unorganised segments the fight for market share does not stay limited between the players of the organised segment but spills over as a broad based market share capture of the unorganised segment by the leading players from the organised group. It is easier for the organised players to capture market share in a market structure where 50% or more of the market is made up of the unorganised sector.

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By definition, the unorganised sector suffers from lack of operating efficiencies due to non-availability of management bandwidth and financial support as most of the unorganised players are family managed businesses who are happy to retain their income rather than grow it year on year. Business expansion in the unorganised segment happens when a family member reaches working age even while access to cheap funding is limited and business economics is created by avoiding taxes and circumventing other legal and financial regulations. Their only advantage is cheap cost of operations and the ability to be flexible at short notice.

On the other hand, when these companies are challenged by their larger counterparts who have easy access to both equity and debt funding, professional management and an overall understanding of market dynamics with targets to grow year on year, the organised sector keeps gaining market share even as moderate growth for the overall market generates high growth for the organised players.

Consider a case of a large sector in India dominated by the unorganised players. Let us assume the organised sector to be 15% of the ₹15,000 crore market while the balance is made up of the unorganised players. So if the overall market grows at 10% an amount of ₹1,500 crore gets added to the market and if the unorganised segment wanted to grow at even 8% it leaves the organised sector with around 21.3% to grow at. Kajaria Ceramics is one company that keeps growing at reasonable rates of growth even as the overall industry grows moderately because the slow growing unorganised players make up for almost 50% of the market.

HOW THE ORGANISED MARKET GROWS FASTER AT THE COST OF THE UNORGANISED ONE?

Period	Market	Organised	Unorganised
Market Share	100%	15%	85%
Year 1	15,000	2,250	12,750
Year 2	16,500	2,730	13,770
Growth	10%	21.33%	8%

(figure in ₹ crores)

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The variance for every percentage difference in growth rates between the organised and unorganised segments will depend on the extent of relative market share as the growth in the organised market increases exponentially for each percentage lower growth in the unorganised space. In the above example, a 2% difference in growth rate between the unorganised (8%) and the total market (10%) leads to a 21.3% growth for the organised segment. One can work this number out at different levels of growth and the results will be quite revealing as is elucidated below:

THE ORGANISED MARKET EXPANDS FASTER AT THE COST OF THE UNORGANISED ONE UNDER DIFFERENTIAL RATES OF GROWTH.

Period	Overall Market	Organized	Unorganized
Market Share	100%	15%	85%
Growth		21.3%	8%
		27.00%	7%
		32.67%	6%
		38.33%	5%
		55.33%	2%
		66.67%	0%

LACK OF AUTHENTIC DATA:

The data that defines the extent of the organised and the unorganised market segments, is in most case erroneous and flawed. The entire market structure in case of segments dominated by the unorganised space remains undefined and unknown because most of the unorganised players do not file their actual numbers with the regulatory authorise either because they do not have them or because they prefer not to disclose too much in the fear of being subjected to higher taxes than what they are willing to pay.

WHERE VALUE GROWTH IS SIGNIFICANTLY MORE THAN VOLUME GROWTH:

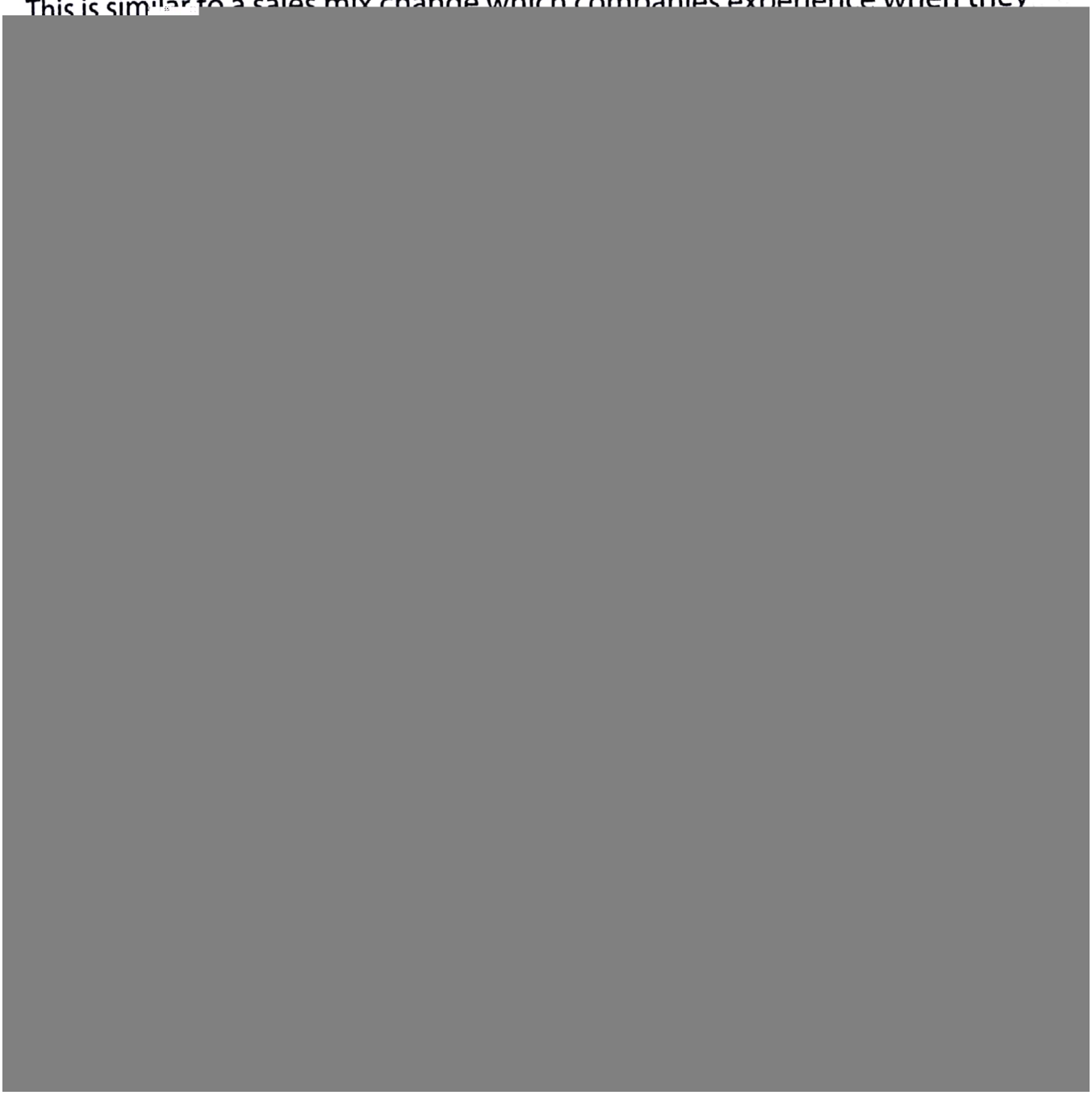
Another aspect to note here is that in case of some products there is a wide disparity in the selling price of goods between the organised and the

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unorganised segments. For instance, in the cooker industry one cooker in the organised segment sells for ₹1,000 whereas a comparable cooker of equal size and capacity in the unorganised space sells at ₹600. In this case, a one percentage movement of the market from the unorganised to the organised segment actually expands the market for a significantly higher value growth.

Such a market size expansion takes place where there is a) presence of both the organised and the unorganised segments b) the market actually shifts from the unorganised to the organised segment i.e. where a customer moves from a perceived inferior product to a better known brand and c) the difference in price range of the two products is large.

This is similar to a sales mix change which companies experience when they



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wheeler player in the 1980's with its Lambretta brand selling 35,000 scooters in 1980-81. In the next six years, the figure dropped to 4,500 scooters as Hero Honda joined the two wheeler market and Bajaj continued to expand and innovate, though a little later. In the early1990's while Doordarshan continued with its five hour a day programming schedule private television broadcaster Zee TV brought in a 24 hour cable channel taking the market away from the state run broadcaster. Private airlines were asked to come in from early 1990's and from a virtual monopoly Air India was pushed to the brink of bankruptcy. In 1996, telecom was a state monopoly with MTNL and BSNL controlling almost the entire market and as the sector opened up for mobile telephony and the private sector accorded a level playing field, new players like Airtel, Hutch (now Vodafone) and Reliance Communications took over the new wireless market. Meanwhile, the state run units in spite of their database of existing customers were pushed out of the market because there was no incentive to the people in charge to see these units compete well on equal footing.

It was the government's job to build roads, bridges, dams and airports prior to 2003 but post that the private infrastructure companies have taken over the market from the government in a smooth and uninterrupted fashion; in the power generation and distribution space the government has lost market share to private players and so it did in the power equipment manufacturing space with BHEL being outclassed by the growth of Alstom-Bharat Forge, JSW- Toshiba, BGR, L&T and the cheap Chinese and Korean imports. *It is clear that where ever there has been a government market share up for grabs and a level playing field accorded to all the participants it gets transferred to the private space more easily than one can think.*

Overall, a company that grows its revenues and profits by growing its market share is more likely to sustain itself over a longer period of time than a company which grows its revenues and profits by merely maintaining market share. Growth without market share capture will be temporary for a company when compared to the one that grows by taking away the market from its competitor.

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Chapter 20

EVALUATING THE MANAGEMENT OF A BUSINESS

The management's integrity of any stock is like the reputation of an unmarried girl. The market never gives it a second chance!

An investor who buys shares in a company while agreeing to be a part owner of that business also enters into an implied partnership with the management* of that company to participate in the success and failure of the business whose part owner he has become. It is therefore imperative for the minority owner of the business to evaluate the credibility, honesty and work drive of the majority owner. While doing so it is essential to keep in mind that honesty by itself means nothing and for shareholders to gain from a stock the management of the company should also be effective in



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has serious reasons to doubt the integrity of his senior business partner (promoter). In the absence of any indication to the contrary an investor while evaluating the management should generally follow the theory that a person is innocent till proven guilty because most of the debate on management quality happens around the small caps whose potential for gains remains multifold and hence the costs of exiting an investment due to faulty judgement is very high.

While only a few managements acknowledge their responsibilities towards their minority partners what is generally overlooked is that the market cap of the company and consequently the wealth of the majority owners (promoters) is decided by the price discovered by the minority shareholders of the business. This puts all takeovers, mergers and promoter sell outs under the influence of the value that the minority shareholders collectively put on the company.

MANAGEMENT PEDIGREE MATTERS MORE IN BEAR MARKETS:

While management pedigree is an essential feature of investment analysis the importance of being with a good management diminishes a little in a bull market and increases manifold in a bearish one. When a sector is in demand very few care about the management integrity and for which, these investors pay the price later on. A suspicious management will generally use a bull market to get into a nexus with operators and market manipulators with a view to increasing the price of the stock. On the other hand, businesses managed by managers of reasonable integrity would never entertain any direct or indirect operator dealings and will always let the stock price find its own level based on the collective wisdom of the market participants.

In a bull market good stocks rise first, on merit which is then followed by the weak names aided by manipulation of both the financials as well as the price. When the bull phase subsides as it always does, the fraudulent companies whose stocks were bid up several times ahead of what their financials would have ideally reflected encounter massive selling both by operators, manipulators and the ordinary speculator who had got in to make a quick buck. While all stocks good or bad fall in a bear market, the good ones are the first to stop falling and are more prone to rise and recover on the first

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signs of stability. The bad ones however, take years if not decades to come anywhere close to their old highs while a few out of these are delisted and removed from trading for ever.

There are no set rules to evaluate the management of a business. The arguments listed in the chapter on 'Stocks to avoid' applies as much to this chapter with minor modifications. As there are no predefined formulas to grade the integrity of a management the process of evaluation is based on a set of small signals that originate primarily from the financials of the company.

SECTOR LEADERSHIP:

The easiest way to identify a good management is to look for a sector leader. The sector leader is a company that generates the maximum amount of revenue in the sector. These leading stocks of the sector will invariably have a good management. It isn't difficult to decipher that the management of ACC was better than a Modi Cement or a Kakatiya Cement or that Infosys was better managed than a Satyam or a Mastek; L&T scored over a Nagarjuna Construction or a Page Industries and Jubliant Foodworks are better run than a Lovable Lingerie or a Speciality Restaurants. Its the character of the management that takes a stock up the sector leadership path.

Just as there are no fixed theories in the market both DLF and Unitech, the sector leaders of the real estate run of 2003 to 2008 had managements that could not be equated with the best and had left several questions unanswered for the minority investors.

LOW DEBT:

A dishonest management never runs a debt free company. If the management is dishonest there is a large chance that the company will not be debt free. Most of the companies where the management was supposed to be stealing from shareholders were embraced with a lot of debt which was increasing year on year and in some cases the rate of growth in debt was higher than the rate of growth in revenues. But as debt forms an integral part of the

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banking and the NBFC business this logic cannot be used there with as much conviction as it can be for other businesses.

GENERATING A HIGH ROE:

A strong and credible management will generate a high RoE. There are bad managements in great businesses and there are great managements in bad businesses but over a period of time an investor makes money if he is able to identify a great management in a great business. A bad management in a great business will not be able to generate any substantial benefit for its shareholders but will find it extremely hard to cause any long term damage to the business whereas a bad management would take only a couple of years to destroy a bad business. Vijay Mallya is a good example of this where the liquor business survived years of bad management while the airline business had to be wound up in a few years of mismanagement. Value unlocking in a great business run by a not so great management happens when there is a change in the management as it happened in the case of United Spirits after Vijay Mallya sold out to Diageo as the stock rose around 150% even before the new management assumed office.

A company with a robust product does not need too much of management skill for its revival. In the the mid 1990's, ITC went in for multiple expansions in inferior grade low RoE businesses like hotels, paper, financial services and aquaculture. Added to these mindless diversifications was the Supreme Court case of 1996 when the company was asked to cough up a ₹803 crore excise duty which ultimately went in favour of the company. However, the inherent strength of the cigarette business helped it survive these regulatory and strategic setbacks.

Similarly, there are good managements running bad commodity cyclical businesses. In these cases, the contribution of the management to deliver above average shareholder returns remains limited. Tata Steel, Tata Global Beverages, Tata Chemicals are few such businesses where even the best of managements have been unable to generate any significant long term shareholder returns. However, a good management in a bad business does not take the company on the path to business mortality so while Tata Steel

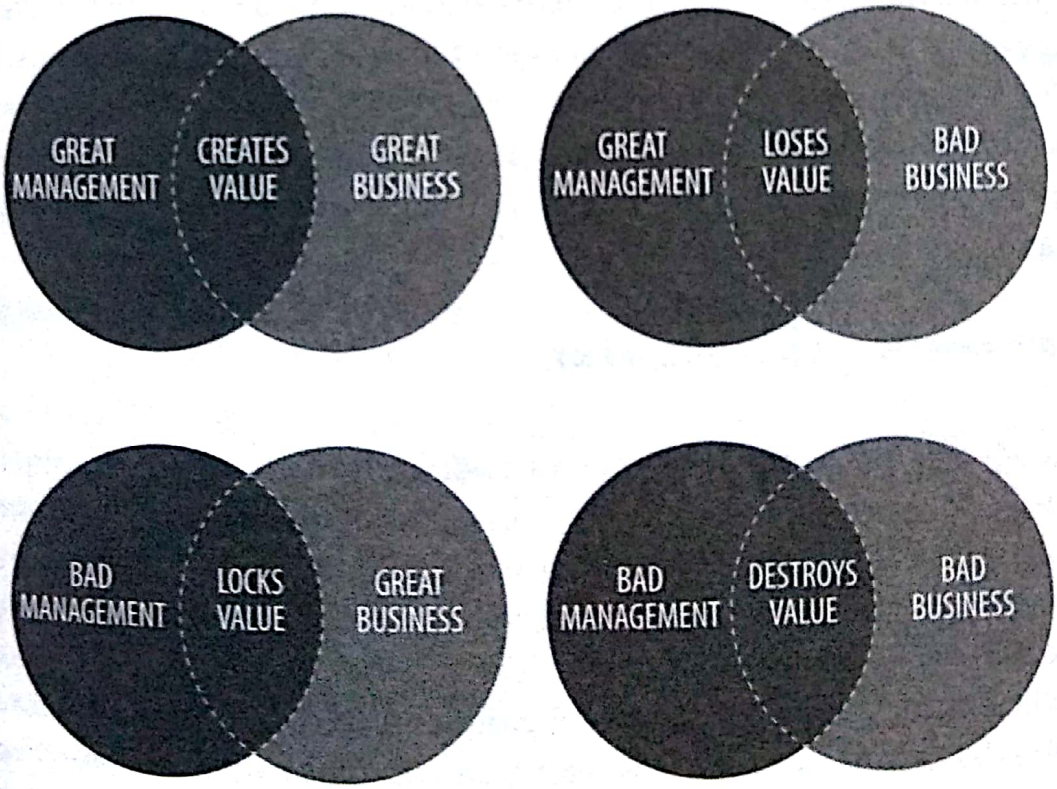
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and Jindal Steel have survived several steel cycles the other lesser known names like Lloyd Steel have caved in due to lack of a proper management force.

On the other hand, a great management in a great business is a wonderful combination. Companies like TCS, ITC, Infosys, Sun Pharma and most of the consumer and pharmaceutical names fall in this category.

Management quality matters, but its significance is subject to the underlying character of the business. *A bad management in a great business locks up value, a great management in a bad business loses value, a bad management in a bad business destroys value, but its only a great management in a great business that can create value.*

THE MANAGEMENT BUSINESS RELATIONSHIP



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An investor who is focused on not losing too much money from stocks should be really biased against companies that are not managed transparently even if it comes at the cost of losing an opportunity. *The loss from not capitalising from an opportunity can be made up anytime but the loss from becoming a part owner of a business managed by a thug is permanent and irrecoverable.*

OPERATING HISTORY:

While looking at management quality it is imperative to look at the long term operating history of a company. A company that has grown revenues at a steady rate for longer periods of time without taking too much debt while generating a high degree of RoE and by keeping a reasonable payout ratio will essentially have a honest and effective management. Companies that are managed by people with suspicious integrity will not be able to grow at a steady rate for longer periods of time.

ISSUE OF WARRANTS AT A DISCOUNT:

Promoters who issue warrants to themselves at a large discount to the market price are also not considered as being fair to the minority shareholders. But is not uncommon for leading bull market stocks to have their promoter issue discounted warrants to themselves and then see stocks move up several times from there even though the price of such stocks tend to fall the most as and when the bull market ends.

OVER AMBITIOUS MANAGEMENT:

Managements that are over ambitious also cause a lot of harm to minority shareholders. An over-ambitious management gets enough ideas from investment bankers and sufficient cash from desperate investors during the pendency of a bull market but when the bull market ends it runs into a vacuum of funding options. One way to identify an over ambitious management is to see the number of group company IPOs that the promoter brings to the market so an over-ambitious promoter like Kishore Biyani started with Pantaloon Retail and soon brought in IPOs of Future Capital and Future Ventures. Similarly, the ADAG group brought in a loss making Reliance

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Power to the market while IndiaBulls which started as a brokerage company slowly diversified into financial services, mortgages, real estate and then into power.

MERGERS, TAKEOVERS AND GROUP COMPANY TRANSACTIONS:

Similarly, a management that undertakes a lot of mergers and takeovers either with or outside the companies related to the promoter group will draw a lot of suspicion. Most of the consultancy reports indicated as basis for valuing the merger or takeover are set up to provide a formal approval to the predefined valuation of the transaction. Companies that have a lot of subsidiaries are also a cause of shareholder discomfort because it makes it easier for promoters to hide their sins under the different layers of corporate ownership.

DIVIDEND AND TAXES:

Dividends and taxes are the two real cash outflows of a business which confirms the genuineness of the financial numbers. Companies that have honest promoters will have a high dividend payout ratio and also pay taxes at the prescribed rate. Companies manipulating the books of accounts don't enjoy paying real cash on manipulated profits and will therefore have a low dividend payout ratio.

EXORBITANT SALARY PAYMENTS:

A management that pays itself a hefty salary isn't prone to cheating any more than a management that does not pay itself a large salary. Its the exorbitant salary payments which draws a concern from the shareholders. On the other hand, a fraudulent management would not take out the money by paying a large salary and subjecting itself to tax. It would look at other ways mostly through the non-official channels to take money off the company. Even in case of a salary one has to look at it in the overall context of things for instance a ₹1 crore salary in a profit of ₹10 crores is more significant than a ₹10 crores salary in a profit of ₹2,000 crores. The promoters of TBZ were paying themselves a large salary prior to the IPO and had promised to reduce

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the salary post listing but the analysts wanted to see a lower salary first before getting interested. Investors who focused too much on how much the promoters were making, lost chance to buy a stock that went up 170% over the next few months of the IPO.

LIMITED VIEW ON FIRST GENERATION PROMOTERS:

Most of the emerging blue chips are promoted by first generation promoters. The market has a very limited opinion on these promoters because of a lack of listing history. In such cases one has to take a holistic view of the opportunity rather than focusing too much on obtaining the specific management attributes. Infosys, Zee TV, Bharti Airtel, Pantaloon, and Unitech were all promoted by first generation promoters which created multifold return for the investors who bought them with a leap of faith.

In case of newly listed IPO stocks without too much history, investors can look at the red herring prospectus and check the financial statements of the previous years to create a framework of opinion on the ability of the management to execute over a longer period of time.

Repco Home Finance was one such company that had come with its IPO in March 2013, at ₹172 a share but was left ignored by a majority of participants because of lack of operating history in the listed avatar even as the stock almost doubled in the next nine months from its listing price. Many a times good quality IPOs are ignored by investors because of their preconceived notion that all IPOs are bad. These investors then wait for the listed company to deliver on the operating performances by which time the stock is already up.

PROMOTER SELLING SHARES:

A promoter that is continuously selling a small quantity of shares isn't such a bad thing as it might normally seem to be. However, if these shares are significantly lowering the promoter holding as it was the case in Geodesic Ltd then there is every reason for the shareholder to get up and take notice.

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The promoters of Page Industries were regular sellers of their stock but their selling except for one major transaction was restricted to a few hundred shares a week. The promoter did not want to hand over its block of shares to any single institutional investor and was hence selling shares in the open market. This repeated selling of shares got under notice as most of the initial investors cashed out at around ₹500 to ₹600. Over the next four years the stock moved up to more than ₹5,600!

DISCLOSURE STANDARDS IN THE ANNUAL REPORT:

The quality of disclosure in the annual report also indicates the scale of financial transparency. Contrary to popular belief, the thickness of the annual report and the number of paragraphs and pictures on the social objectives of business like setting up schools and hospitals don't speak about the level of corporate governance at all. Investing in the markets is all about capitalism and should be focused on RoE rather than the number of free cataract operations a management has conducted. These elements of corporate social responsibility are items that have little meaning on whether the stock will go up or come down. Disclosures that the investor likes to hear are ways in which the management intends to use its spare cash, increase market share and focus on RoE. When I bought Page in 2009, the worry was about understanding as to what would happen if the management gets into the backward integration plan of manufacturing yarn to which the management replied that it would not undertake any venture which gives it an incremental RoCE of less than 35%. They further stated that they have two hundred vendors to buy yarn from. Why should they compete in such a crowded field?

Some companies by design don't talk too much through their annual reports. Hawkins Cooker has for reasons known to itself kept the number of pages in its annual report constant at thirty two for the last few years. This does not mean that the company isn't shareholder friendly because the cash flow that it generates and the dividend it declares more than compensates the investor for the lack of advance business information.

Overall, there are no clear cut rules to understanding the management of a company. An astute investor will get most of the cues from circumstantial

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evidence which may or may not turn out to be correct. It therefore makes sense to focus on the financials of a company especially the RoE, growth and the payout ratio that provides a reasonable indication on the management of a company but irrespective of financials there can be little value for a long term investor in a stock with a questionable management.

As most of these aspects of understanding managerial integrity are circumstantial rather than conformational if the company is acting right, an investor should ignore the circumstantial evidence and focus on the numbers at hand instead. However, once an investor has sufficient reason to feel that the management isn't worth trusting, he should avoid the company rather than invest with the hope that the people managing the business will change. No matter how much effort a giraffe puts in, he cannot run like a horse nor can a horse become as tall as a giraffe but if he does then there are terrific gains to be made. Shree Cements was one company whose management changed from the mediocre to the good by bringing transparency in operations and shareholder communication. This enhanced integrity in reflecting the profitability to the shareholders and the markets sent the stock up several times since the start of this decade but for every Shree Cements there are several Satyams sitting in the market - refusing to change.

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Chapter 21

DIVIDEND - THE ONLY SURE THING FROM A STOCK

Margin of safety is not in the intrinsic value but in the dividend yield. Intrinsic value is a function of market perception while dividend is the real thing.

In a study undertaken in America it was observed that capital gains accounted for only 53% of all shareholder gains whereas the other 47% was generated from the dividend payoffs. Dividends are the only tangible benefit that an investor receives from owning shares in a company and reflects a lot on various aspects of his investment ranging from business model, management quality, predictability of earnings and the growth potential of the entity.

Most young investors having limited capital do not pay too much attention to the dividend paying capacity of an investment as their area of focus remains on making capital gains by trying to sell a stock at a price higher than what it was bought for. These investors feel that buying dividend stocks are more suited for the risk averse folks rather than for the aggressive investor, a mistake that they realise after they have spent some time in the market. This is because the quantum of dividend is important not for the actual cash that it generates but more for the signal that it sends to the investing community at large.

LOOK FOR A GROWING YIELD:

A growth stock with rising dividend payout represents a potent investing combination, as the rising yield protects the downside whereas the growth helps in generating the upside.

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A dividend payoff represents one of the most powerful rerating triggers in the investment world and it is incorrect to assume that multibaggers do not originate from yield alone primarily because a growing yield decreases the risk of investing and helps an investor in creating the right kind of mental framework to bet without fear. *Stocks which report an increase in revenue and earnings with a commensurate increase in dividend payout represent those rare breed of stocks whose prices go up without falling down a great deal.* Page Industries is one such stock which continues to grow earnings at an annualised rate of above 30% while simultaneously distributing 45% of its profits as dividends. The stock of Page has rarely fallen by more than 20% from its all time high price, anytime in the last five years. On the other hand, companies that report increase in revenue and earnings without a proportionate increase in dividends can also see their stock price rise a great deal buoyed by the tailwinds of the sector. But when the tide turns an absence of a healthy payout ratio causes the rise in stock price to reverse into an equally devastating fall. *A company whose stock goes up on dividends is more prone to retaining its increase in market cap than a company whose stock price rises from increase in earnings alone without a corresponding increase in dividend payout.* Future Retail the erstwhile Pantaloon Retail grew revenue and earnings without a commensurate increase in dividend payouts and the stock collapsed after the 2008 bull market whereas Titan Industries a stock that had an established 25% payout is up 3 times (adjusted for splits and bonus) on its 2008 high.

OVER THE LONG TERM GROWTH IN DIVIDENDS INFLUENCES THE STOCK PRICE.

Company	Financial Period	Price CAGR	Revenue CAGR	Profit CAGR	Dividend CAGR	Business RoE
VST Industries	2001 - 13	24.4%	6.3%	13.5%	30.77%	40%
Hawkins Cooker	2008 - 13	69.5%	15.8%	24.8%	38%	70%
Page Industries	2008 - 13	51.5%	35.3%	36.4%	38%	60%
Nestlé	2002 - 12	25.3%	15.6%	17.8%	10.4%	60%
Colgate	2002 - 13	21.9%	9.9%	19.5%	18.7%	100%

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Having a reasonable payout ratio isn't just about downside protection from the buying price after all its also about retaining the gains.

A look at the companies above indicates how the compounded annual growth in price of these stocks were influenced by the different growth parameters but over the longer term price tended to equate itself with the growth in dividends. Generally, the growth in market price exceeded the growth in dividend payments except in cases where the company grew revenue at abysmally low rates when compared to a growth in dividends. VST Industries was one such company where the annualised revenue growth of 6.5% was far lower than the dividend growth of 30.77% while the stock price grew at a CAGR of 24.4% for the period 2001 to 2013.

Even though the dividend growth between Hawkins Cooker and Page Industries remains the same between March 2008 and March 2013, the stock price appreciation in Hawkins Cooker has been slightly ahead. This is in spite of the fact that the profit and revenue growth of Hawkins has lagged behind that of Page. One reason for this outperformance at Hawkins could be the P/E rerating as in March 2008 Hawkins was a 5% yield stock available at a single digit P/E unlike the slighty more expensive valuations of Page Industries.

DOES NOT ACT AS GRAVITY ON GROWTH:

The negative aspect of a company declaring a regular and generous dividend is that a strong dividend payout theoretically restricts the ability of a company to grow at higher rates as dividends paid out of profits could have otherwise been used to generate further growth. *Companies that report a high RoE should therefore be retaining their cash to augment their growth plans when compared to companies that report a low RoE. However, the counter argument is that no company gives out a dividend at the risk of growing at a smaller pace but instead distributes only that part of its income which it cannot use for further growth because it does not foresee itself growing at higher rates due to non-availability of growth opportunities.* That is, when a company encounters challenging market opportunities for a level of growth beyond a certain number, it chooses to distribute its surplus as dividends to its shareholders rather than retain the cash on its balance sheet. An example here are the multinational FMCG names which in spite of generating more than 70% RoE pay out a substantial chunk

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of their profits as dividends because they foresee themselves growing at between 18% to 20% only.

THE PARADOX OF HIGH ROE

In theory, companies that generate a high RoE should be retaining all that they make but the paradox is that companies that generate a high RoE are cash flow positive and asset light and do not need too much cash to grow and are therefore willing to pay off the surplus as dividends. On the other hand, companies that generate low RoE should ideally be throwing back all the cash so that an investor can put it elsewhere for better returns but the low RoE companies need the cash to grow and are unable to release anything without disturbing the business and hence remain asset heavy while generating negative cash flows. Its the cause and the effect at play because the fact that they need too much of capital to grow remains the primary reason for their low RoEs.

HIGH PAYOUT LEADS TO A HIGH P/E:

While discussing dividends it is important to discuss the relationship between the dividend payout ratio with the dividend yield. Generally, the payout ratio divided by the yield of a stock leads us to the P/E ratio or the P/E ratio is positively influenced by a higher payout ratio.

Dividend Payout Ratio (divided by) Dividend Yield = P/E Ratio

$$\text{or } \frac{\text{Dividend per share/EPS}}{\text{Dividend per share/Market Price}} = \text{P/E Ratio}$$

$$\text{or } \frac{\cancel{\text{Dividend per share}}/\text{EPS}}{\cancel{\text{Dividend per share}}/\text{Market Price}} = \text{P/E Ratio}$$

or Market Price / EPS = P/E Ratio

This relationship does not indicate the fair P/E of the stock but is just an expression that represents a tendency of a high payout ratio leading to a high P/E of a stock but as a high payout also indicates lower growth potential of the business it contradicts the generally held notion that P/E is just a function of growth.

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SUSTAINABILITY AND EXTENT OF PAYOUTS:

While operating dividend should be segregated from a one time special dividend it is important to look at both the current yield and the trend of the payout over the last several years. *Dividend yield in a secular growth business is more significant than yield computed for a cyclical business as due to their volatile nature of earnings, a cyclical company is more prone to abandoning a set pattern of dividend* payments when compared to dividends from a secular growth business.

The extent of payout ratio is also important in computing the significance of the yield. A company paying a ₹4 dividend out of an EPS of ₹10 is more likely to continue with the dividend than a company with a dividend payment of ₹7 out of an EPS of ₹10. Some companies like Hindustan Unilever Ltd had a near 90% dividend payout for a major part of the last decade but the market valued it on the basis of its dividend payout as its earnings and dividends were predictable. On the other hand, an infrastructure company like Blue Star was not trusted for its 35% payout ratio as its revenues and earnings could not be accurately predicted and when the cycle turned, the company slipped into losses as it was left with no option but to abandon its payout plan.

BONUS SHARES FOR DIVIDENDS ARE BOGUS:

Some companies pay dividends in the form of bonus shares. Such a dividend signifies nothing and should be ignored as it does not result in a direct cash transfer to shareholders. The primary objective of a dividend cheque is to satisfy the minority owners that the company's profits are genuine. Opto Circuits was one such company that declared dividends by capitalising its reserves to issue bonus shares sending dividends in electronic form through demat accounts. Such a dividend had zero value because it was a mere book entry and said nothing about the cash paying capacity of the entity. The stock price of Opto Circuits finally fell 95% from a high of ₹257 in January 2008 to ₹25 by June 2013.

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TAKING DEBT AND DISTRIBUTING DIVIDENDS:

The financials of a company that takes debt and distributes dividend is a cause for concern. However, in some cases as under the Textile up-gradation fund TUF loan schemes applicable to textile companies the interest on debt is subsidised and hence such companies can continue to distribute dividends as the cost of debt after adjusting for subsidy and income tax remains low. A subsidised loan comes with a 6% interest and as that interest on loan is used for claiming a tax deduction the net cost to the company assuming a 30% tax rate comes to 4.2% (6% - 30% of 6%). A company that distributes dividends even while its cash from operations is consistently negative is a time bomb - waiting to explode.

ESTABLISHING THE DIVIDEND CHARACTER OF A BUSINESS:

An ideal dividend distribution ratio is around 25% to 30% of the net profits but in order to establish the dividend character of a company the management should disclose the payout ratio in advance. Such a disclosure helps investors to decipher the trend of dividend payouts. *A management that has a stated payout policy gets better recognition from the market in terms of stock valuation from another whose payout policy remains unstated.* A company that pays dividends remains leaner with cash which also saves its investors from the threat of the company making an uneconomical RoE dilutive acquisition. A management that retains cash on balance sheet without any specific purpose is more likely to deploy this cash into inferior businesses.

Most of the dividend paying companies have a set of very long term investors who have held onto the stock for decades and rely on these dividends for their day to day expenses. It is for this reason that companies are reluctant to effect changes in dividend payout policies as rapid changes in the payout ratio sends conflicting signals to the investors.

DIVIDEND GROWTH QUOTIENT:

An ideal investment bet is a company that grows not just its revenues and profits but also its dividends at a fast pace. *But companies that want to grow*

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fast need to retain and reinvest their earnings back in the business whereas companies that give out a lot of dividends theoretically can't grow fast. To overcome this problem one should multiply the prospective yield of a stock with the potential revenue growth to arrive at a yield growth quotient. For instance, a 2% yield stock growing at 25% every year can be noted for a yield growth quotient of 50 (25 x 2). Any number above 50 should be considered to be attractive and the attractiveness of a stock should decline with a yield growth quotient of less than 50. In this way, we can arrange the different possibilities as:

THE DIVIDEND GROWTH TRADEOFF	
Dividend yield	**Revenue Growth**
2%	25%
2.5%	20%
3%	17%
4%	12.5%

The logic of this relationship is that if the yield is low it has to be compensated by a higher revenue growth. Investors should accept a lower growth only if the stock has a higher dividend yield. This is not a watertight classification and just represents a tendency which encourages the investor to look for dividend or growth to find a reasonable trade off between the two. Some stocks are traded cheap without growth and in that case an investor should seek dividends whereas in some high growth stocks an investor can ignore the dividend if the growth appears to be robust and sustainable.

DIVIDEND YIELD AS A VALUATION TOOL:

Some stocks get their valuation because of the dividend yield. VST Industries, a high quality cigarette company with predictable earnings stream paid a dividend of ₹62.50 per share out of its Fy13 EPS of ₹81.76 indicating a payout ratio of 76.4%. When companies declare dividends they attract a dividend distribution tax of 16.995% so a company with a 76.4% payout actually incurs

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a payout of 76.4% plus the dividend distribution tax. The dividend distribution tax thus makes 85.47% as a theoretical ceiling for dividend payout as a dividend distribution tax on the same will take the total outflow to up to 100%. Any company that declares a dividend of more than 85.47% of its profits under the present dividend distribution tax of 16.995% will do so by drawing upon its old reserves only. Companies engaging in share buybacks though, don't attract any such taxes from the government.

The long term secular revenue growth of VST has been less than 10% whereas in some good years it has managed to grow its top line by even 15%. If the market assigns a P/E of 10 to this stock then the stock will trade at a price of ₹817 which with a ₹62.5 dividend would result in a tax free yield of 7.64%. *The price of a high quality company with pricing power and a visible earnings stream cannot fall to a point to equate the P/E ratio with the long term growth because at that point the tax free dividend yield which is growing at a certain number will exceed the post tax bank fixed deposit interest especially because the interest from a bank fixed deposit will remain constant for the entire length of the deposit whereas the dividend will be a growing number.* That is why the price stabilises at a point where the yield is between 3% to 4%. Due to the high payout ratio the price discovery happens at around ₹1,785 or at a 3.5% yield and the P/E at that price comes to around 22 times as the high payout ratio artificially expands the P/E. Analysts would keep releasing sell reports stating that in view of the 10% long term revenue growth the P/E of 22 times is unsustainable but the stock would refuse to come down as it gets its valuation because of the yield and not because of the P/E. In this case, the P/E is a number that is an offshoot of the dividend yield.

Consider the price of HUL in the period 2001 to 2010 when the stock moved in the range of ₹200 to ₹300 at a P/E of 25 to 30 times in spite of growing revenues at around 10% CAGR. The company used to pay a dividend of around ₹5 to ₹9 and the price was only justifying the yield while a few participants were tearing their hair off each time they tried computing the P/E of the stock by looking at earnings in isolation of the yield.

Instead of declaring cash dividends some companies declare dividends in the form of bonus debentures which are also known as deemed dividends. These debentures are instruments of debt, carrying a fixed rate of interest and

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redeemable after a fixed period of time. The company also benefits by retaining immediate liquidity and sending out a definite payout signal at the same time.

In 2003, HUL became the first Indian company to declare bonus debentures. For every ₹1 face value of shares its shareholders were awarded ₹6 worth of debentures carrying an interest rate of 9% per annum. These debentures were to be redeemed in two equal instalments of ₹3 each in the second and third year of issue. The markets greeted this announcement sending the relatively silent HUL stock up 8% on the day of the announcement. These debentures also helped the company in increasing the RoE by drawing upon the general reserves account which reduced the shareholder funds in the balance sheet. While interest on debentures also reduces the net profit the effect was marginal because these interest payments also reduced the tax liability of the company, as debenture interest qualified as an expense for income tax computation. In 2009, Britannia also declared bonus debentures with a face value of ₹170 and carrying an annual coupon of 8.25%, redeemable at the end of 36 months.

Overall, dividend remains a signal by the majority owners to the minority shareholders that all is well within the company and that a company which has an established record of dividend payout is slated to provide additional investment comfort than another company whose dividend policy is yet not established. While shareholders can chase growth over the shorter period the real indicator of wealth over the long term remains the ability of the company to distribute its profits in the form of divided payments.

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“The purchase price has nothing to do with what the stock will do from today.”

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OPERATING LEVERAGE-LOOKING FOR MARGIN EXPANSION

A 15 bagger with a 3% allocation makes a career but a 15 bagger on a 30% allocation can make a life!

One of the popular ways of making money is to buy fast growing businesses which are on way to becoming the potential leaders of the next bull run. These fast growing companies, aided by the earnings growth momentum become cheap with each passing year so a company growing at 25% CAGR and available at a P/E of 30 times becomes a 15 P/E stock in three years and a 7.5 P/E stock in six years assuming the 25% growth comes around uninterrupted.

Unlike these secular fast growing stories there are another set of companies with potential to become multibaggers more because of margin expansion than due to the sheer growth in revenues. These unsung heroes who display reasonable sales growth are generally less talked about and are in several cases not as actively followed and researched like their fast growing cousins. Markets love growth and are willing to pay top dollar for a company that can promise uninterrupted long term secular growth. It values a 25% to 30% revenue grower very differently from a 18% to 20% grower even though the moderately growing company could potentially expand margins to achieve a higher earnings growth.

These companies might grow revenues at around 18% to 20% only but could be situated on the cusp of a strong margin expansion. *A company which grows sales at 20% CAGR for five years and experiences a net profit margin expansion from 6% to 10% generates a 32.9% compounded annual profit growth over this five year period.*

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DIFFICULT TO SUSTAIN A MARGIN EXPANSION:

Identifying companies that are ready for margin expansion is a rare event as under normal circumstances profit margins tend to move within a range and do not expand beyond a point. The nature of the business is one of the most important aspects of determining the profit margin of that business and hence forecasting a margin expansion remains a function of the business dynamics within which the company operates. Companies that have a strong business model have higher and stable margins whereas companies that have weak business models have lower and volatile margins.

Most cyclical companies experience a margin expansion during an upswing but this expansion in margins is given back as soon as the cycle reverses. A margin expansion in such companies isn't taken too seriously by the market when compared to those companies that can demonstrate to the market that its margin expansion is sustainable over longer periods of time.

Looking for margin expansion from moderate growth companies is not a popular research idea with analysts and brokerages and most of them prefer to remain focused on estimating the profitability of a company in a linear relationship to the revenue of the business. *It is much easier to predict revenue growth than to forecast margin expansion* and that is why whether it is the secular growth business or the cyclical turnarounds only a few research reports are written predicting whether the margins of a company are going to expand or contract. In many cases, even the management of these companies are not sure whether they will experience a change in margins or not as these margin movements are as much related to the internal efficiencies of a company as it is derived from a favourable external environment.

When a company expands output it adds less to its fixed costs and hence the increase in revenue creates a more than proportionate increase in profits. All companies experience operating leverage during times of a business expansion. For a given level of gross margin the operating leverage is more pronounced for companies reporting a low net profit margin than for high net margin companies primarily because of the lower base that these low net margin companies have created for themselves.

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PRICING POWER:

A company which incurs an operating leverage resulting in a permanent margin expansion could have a few things working for it. At the outset it should be selling a product or service which has pricing power so any increase in input costs could be easily transferred to the customer. An investor should recall how ITC raises the price of its cigarettes by 10% to 15% to offset any impact of input or tax increase. *Generally, in a competitive market structure where each firm is unable to distinguish its products from the other all savings are quickly rolled back to the customer either in terms of better products or lower prices which restrains most companies to move away from the traditional margin setup. A company that sells life saving drugs is more likely to retain the excess profits than a company which is engaged in the shipping business. The focus remains on whether the bargaining strength lies with the buyer or the seller or is equally distributed between the two. In case of a business without entry barriers margin expansion will normally be temporary and transient* so a Tata Steel can work with a net profit margin of above 15% when the steel cycle is in full swing which then drops into the negative territory with the collapse of the cycle.

A margin expansion is more likely to occur in companies using cyclical inputs even as they retain the pricing power of their finished products. A cyclical input will over time experience lower increase in prices when compared to the finished product that this cyclical input is being used to manufacture. A company which takes a price increase of 6% to 8% each year will over time create a large gap between the selling price and the raw material component, giving rise to expansion in both the gross and net margins.

THE GROSS TO NET MARGIN RATIO:

Companies with a high gross margin and a low net margin are more likely to experience an expansion in margins. Generally, higher the disparity between the two more the likelihood of a margin expansion. A company with a gross margin of 60% and a net margin of 10% is more likely to have a margin expansion than a company with a gross margin of 40% and a net margin of 10%. A simple rule of thumb is to be on the lookout for a gross to

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net margin ratio of 6 times. In case of VST Industries, the ratio of gross to net margin was as high as 8 times in the year 2000 and even though the company's gross margin expanded over time the increase in net margin was more pronounced and elaborate as it expanded to around 20% from less than 5% in 2001.

REVENUES SHOULD RISE FASTER THAN COST:

A company that is poised for margin expansion should also be growing revenues at a moderate pace if not at a very high rate. The cost structure on the other hand should preferably be loaded towards the fixed side which would ensure that the growth in revenues because of the economies of scale would result in a less than equal growth in costs thus expanding margins and growing profits at a higher rate than sales.

Generating a margin expansion also needs a cultural change as companies find new ways to spend excess profits. A strict cost control is hence an important attribute of ensuring a margin expansion. Most non-cyclical companies don't experience a margin expansion too quickly and for the cyclical businesses the margin expansion does not matter as markets don't rerate companies that experience cyclical margin upswings.

MARKETS DON'T LIKE MARGIN EXPANSION FROM SAVINGS IN INTEREST COSTS:

Markets do not fancy companies that increase their profit margins by savings in interest costs during a falling interest rate environment. They are more eager to see bottom line growth based out of an increasing revenue or improving operating efficiencies. *One way of understanding this is to look for companies that improve their net profit margin by increasing margins at the operating or EBIDTA level rather than companies which just improve the net profit margin while the EBIDTA remains more or less the same.*

Once a company experiences a margin expansion with an above average revenue growth, the price earnings ratio also expands resulting in a disproportionately higher gain for the initial investor. Consider a TV broadcast

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station with fixed programming and distribution costs, if this company were to suddenly experience an increase in viewership the company would negotiate for better advertisement rates from advertisers which when coupled with increased subscription revenues will put the profit growth much ahead of the sales growth. In this case, the increase in profits will outpace the increase in sales as a television station works with a fixed cost structure.

HOW MARGINS EXPAND?			
	Year 1	**Year 2**	**Growth**
Sales	100	125	25%
Raw Material & other variable costs	60	75	25%
Gross profits	40	50	25%
Gross margin	40%	40%	
Other costs	30	34.50	15%
Profit before Tax	10	15.50	55%
Tax @30%	3	4.65	55%
Net profit	7	10.85	55%
Net profit Margin	7%	8.68%	168 basis points

In the above case a 25% increase in sales caused a stupendous 55% increase in profits causing the net profit margin to expand 168 basis points to 8.68%. This kind of growth isn't normal but happens quite often to companies that display a specific set of attributes as noted above. In the above example we assume that the 25% increase in sales will also come with a similar increase in raw material and other direct costs. These costs are known as variable costs because they have an established linearity with increase in production. Theoretically, the expenses of direct labour and other production costs should also be included as part of variable expenses but in the absence of specific data on most publicly listed companies we are considering only the raw material costs as part of fully variable costs. On the other hand, increase in

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semi-variable and fixed costs are not linear to the increase in production because salaries, rent etc do not increase in proportion to the overall sales. It is therefore estimated that these fixed administrative costs are assumed to increase by 15% only, ahead of the general rate of inflation.

Companies that grow at a fast clip experience natural operating leverage. But to understand the impact of operating leverage an investor should ask the company management on the extent to which the fixed costs are a part of the overall cost structure. Companies which have a higher percentage of variable costs can generate margin expansion only by increasing their gross margin.

VST was an exception, generally a margin expansion is facilitated by an increase in revenue, as growing revenues creates operating leverage and though it isn't easy to predict a margin expansion *a stock with rising revenues, increasing margins and an expanding P/E is potentially a big multibagger which does not come too often but when it does all an investor should do is to pull the trigger and fire rather than debate too much on the purchase price.*

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HOW COMPANIES COOK BOOKS OF ACCOUNTS?

What a company does in its market matters more than what the participants do to the market price of the company.

There are no foolproof ways of picking out companies that cook their books of accounts and most allegations about certain companies and managements fudging numbers are apprehensions based on circumstantial evidence only. The stock market is however very smart and proactive in valuing companies that are fudging numbers as it pulls down the price of such stocks much before the actual number fudging comes to the fore.

Till a few years back several Indian promoters siphoned off money from the company by under-stating revenues and profits so that they were subjected to lesser taxes. But as promoters realised the concept of market cap and the resultant wealth effect that it creates, the nature of misrepresenting accounts have changed as companies now engage in cooking books to overstate revenues and profits so as to generate and sustain a higher market cap. *Today's management has become wise to the computation that for each incremental rupee of profits his net-worth in terms of his value of shareholding goes up by the P/E of the stock multiplied by the share of his holding in the company.* In other words, for a company with a promoter holding of 60% and assumed to be trading at a P/E of 10 times, an incremental reporting of profit of ₹10 crores would increase his net worth by ₹6 crores. Why should a promoter be interested in siphoning off ₹1 crore when he gets an incremental wealth effect of six times the number? Investor attention is generally influenced by companies that show a higher growth in sales and profitability and though fudging sales is tougher than manipulating profits a dishonest promoter still finds ways to show what he wants to and in all

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change to conclusive proof before it is too late and by which time the damage has already been done.

OVERSTATING ASSETS:

A company that cooks its numbers to overstate earnings will generally land up with overstating the value of its fixed and current assets because if this money is shown as cash, shareholders might try and pressurise the company to distribute it back as dividends. This is why no company wants to be shown holding cash but tries to convert it into some form of an asset which cannot be forced by shareholders for liquidation. As this money does not exist in reality but is a function of fictitious earnings accumulated over the last several years, the only way for a management to get this fictitious cash on balance sheet out of the way is by acquiring an over priced asset. It is much easy to value cash in the bank than to compute the value of a machinery imported from a foreign country. In 1999, Satyam Computers had bought the India World group of websites consisting of Khoj.com, khel.com, samachar.com etc with revenues of ₹1 crore and a profit of ₹25 lacs, for a staggering all cash ₹499 crores deal. A few years later, Satyam again proposed to buy out its real estate business Maytas at an exorbitant amount of $1.6 billion. Both these deals were done to get the fictitious cash off the balance sheet.

COMPUTE INTEREST ON INCOME EARNED FROM CASH ON BALANCE SHEET:

One way to decipher whether the cash or cash equivalents are for real is to compute the quantum of interest income that the company reports to be receiving against this cash held on its books. Companies like Geodesic and Tanla reported an interest income that was almost 2% of the investment value as reflected in the balance sheet while comparable number for genuine cash on balance sheet companies like Infoedge and Piramal Enterprises are ahead of 6% per annum.

CHECK THE ROE AND ROCE:

The RoE and RoCE answers a lot of questions relating to the world of investing and their relevance also extends to understanding whether the books of

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accounts of a company reflect the correct state of events. Some managements engage in siphoning off cash from the company by taking kickbacks from over-invoiced plant and machinery, setting up false expenditure bills and picking up money from suppliers and distributors. In this process, they either inflate the asset side of the balance sheet or increase the expense side of the income statement.

A firm that manipulates its books to siphon off cash will reflect either lower revenues, higher expenses or a larger block of fixed assets. The fixed assets are valued at a higher rate due to over invoicing of purchases even though the productivity of the assets will remain unchanged. Subsequently, these firms will also employ a higher amount of capital employed while their earnings will be lower because of understated revenues and overstated expenses.

In the above case, a company that was over-invoicing assets and under-reporting profits by showing a higher expenditure will invariably generate a lower RoE and RoCE for the business.

A company that inflates profits for a higher stock valuation will overstate revenues and understate expenses to report a higher net profit.The company that overstates earnings will store its fictitious profits either in fixed assets, inventories, debtors or cash. *In any case, the incremental overstated profit will not leave the asset side of the balance sheet as the company would not declare dividends to pay real cash for fictitious profits. That is why dividend and tax payments are supposed to be very strong indicators of earnings quality.* This increase in the asset side of the balance sheet will work towards reducing the RoE and the RoCE from what it would, had the company shown the actual value of assets.

Alternatively, a company with genuinely higher profits will seek to distribute its unutilised cash as dividend amongst existing shareholders. Hoarding cash (either fictitious or genuine) would decrease the RoE because returns from idle cash on balance sheet would generally be lower than returns from operating assets and hence the RoE would have been dragged down.

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FREQUENT EQUITY DILUTIONS:

A company that cooks numbers will always be eager to raise funds both through equity and debt or rather *a company that wants to undertake frequent equity dilutions will cook up its books of accounts so as to make itself presentable in front of its institutional investors.* The low RoE with limited free cash generation would create growth challenges as the internally generated funds will not be enough to sustain the desired level of growth so a company that repeatedly dilutes equity through placement to institutions and funds is a fit case for forensic accounting. Similarly, a company that is debt free and not diluting equity is not in the process of cooking its numbers and should be viewed in that light. *Empirical evidence does not suggest too many companies to have been cooking numbers and not diluting equity or raising debt at frequent intervals.*

HIGHER RECEIVABLES & INVENTORIES:

A company that reports a sudden increase in inventory and receivables is a cause for concern as inventory and receivables are an ideal place to hide the sins of business. The rate of increase in inventory and receivables should not exceed the rate of increase in revenues unless there is an exceptional reason for the same. A disproportionately large increase in inventories and receivables could indicate that the company has initiated the process of parking some unrealisable assets in these two accounting heads. The business of the company is also relevant for understanding the implications of this increase as receivables from a government entity or a top rated private sector company as part of an originally decided deferred payment option isn't the same as receivables from a firm pending under dispute. Similarly, an inventory of gold for a jewellery company isn't the same as an inventory of ready made garments that runs the risk of going out of fashion. The risk of obsolescence should always be understood while evaluating the inventory figure that is after an investor has reasons to believe that the stated value of inventory is genuine.

In general, a company that grows revenue while disproportionately growing inventory and receivables is a potential case of discomfort and needs to be put under serious scrutiny.

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EXCISE DUTY PAYMENTS:

One way of deciphering whether a company is reporting excess revenues is by looking at the number for payment of excise duty and then checking it to arrive at the revenue figure. Firms may report higher revenues but they seldom pay higher excise duty on these incrementally reported revenues. For instance if excise duty is paid at ₹1,500 per unit and the firm reports an excise duty payment of ₹150 crores it is clear that the firm has produced 1 million units. This should be multiplied by the average selling price to arrive at the revenue number. The average selling price can be obtained from the annual report or any other management communication.

However, if some of the company's plants are operating in excise free zones than an investor will need to make the appropriate allowance to this method. Though this method would not provide an exact figure it would reflect on the genuineness of the revenue figure with a fair degree of approximation. A smart investor can of course talk back to the management on this to clarify the missing links in this computation.

RELATED PARTY TRANSACTIONS:

Companies that report too many related party transactions either through promoter owned companies or with their own subsidiaries should also be out under the scanner. It is generally difficult for an investor to analyse related party transactions in companies that float a web of subsidiaries with cross holdings. DLF had been known to be transacting with DLF Assets a related group company and according to Veritas, a Canada-based research firm, dealings between DLF and DLF Assets had overstated the revenues of DLF by ₹11,236 crores and profit before tax by ₹7,233 crores.

Veritas further argued that these transactions had boosted the value of DLF Assets prior to its being taken over by DLF thereby diluting the interests of minority shareholders in the parent company.

Certain companies make a lot of inter corporate loans and advances to group companies. Sesa Goa was one such company which I missed at the bottom of 2009 because the balance sheet reflected a large amount of loans and

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advances to group companies. *The stock subsequently went up ten times over the next two years which indicates that sometimes the act of over-analysis can be detrimental to buying winning stocks but the truth is that not doing enough homework can also subject an investor to the vulnerability of making losing bets.* If group companies need cash they should be borrowing from banks and institutions instead of a listed company under the same management. Generally, corporate governance standards are inversely proportional to the number of inter company transactions.

TINKERING WITH THE CASH FLOW STATEMENT:

A company can manipulate its income statement and also misrepresent the balance sheet but window dressing its cash flow is tough as the cash flow statement shows real movement of cash. A company that manipulates accounts will find it hard to show a positive operating cash flow. In spite of this, some companies attempt to move the cash flow figures from different classification heads to provide a better financial picture. One of these adjustments relate to companies that undertake External Commercial Borrowings (ECB). These ECBs suffer from mark to market swings due to fluctuations in the exchange rate. Sometimes a company might show the realised and unrealised mark to market gains arising out of these ECBs as part of other income under the 'cash from operations' segment of the cash flow statement. This temporary gain might not be sustainable and hence classifying it under cash from operations provides a false sense of liquidity comfort to the analyst looking at the company's financial statement. Moreover, some companies might put certain unpaid capital account liabilities on account of purchase of any fixed asset as part of sundry creditors which again inflates the cash from operations. As these temporary liabilities might mature for payment within the next 12 months the company might argue for their inclusion under the sundry creditors. However, these liabilities are of a non-recurring nature and hence should be stripped away from the sundry creditors list and shown as part of cash from investing activities.

Some companies also include certain long term pension and employee provident fund liabilities as part of the creditors. Thus, it is imperative to check the schedule of creditors for verifying the items that are a part of the list of creditors because increasing the creditors improves cash from operations which provides a distorted view of the actual financial picture.

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AUDITOR QUALIFICATION:

Sometimes the auditor report carries certain qualifications with regard to the accounting practices adapted by the company. These qualifications may relate to inadequate provisioning for doubtful debts, inappropriate recognition of revenue or costs, disparity in depreciation charged, all of which lead to change in actual profits from what is reported to what the auditor thinks should be reported.

Depreciation policies also influence accounting numbers. The Companies Act prescribes a certain rate of depreciating various assets but some companies depreciate assets at different rates in order to overstate or understate the actual profits. This variance in accounting standards along with other such smaller discrepancies will be available as part of the auditors report.

A red flag is also raised when a company undergoes a change in auditor. In such cases information that is disclosed to the shareholders and the general public is just a small part of what actually transpires before the current auditors are replaced by new ones.

When the company changes a large established firm for a smaller name investors should stand up and take notice. Arshiya International encountered a change in auditors in August, 2009 to MGB & Co because Pricewaterhouse had expressed its unwillingness to continue. Similarly, a change in auditor was made in Educomp before the company embarked on its high growth trajectory.

CASH, DIVIDEND AND DEBT:

There are companies which reflect substantial cash in hand on the asset side while simultaneously reflecting the loans on the liabilities side of the balance sheet. A nominal cash figure is understandable for conducting the day to day operations but if the company reflects a relatively large cash figure on the asset side against 'loans received' on the liabilities side it calls for further scrutiny. Interest on loans taken from a bank is generally more than that what a depositor gets on 'fixed deposits'. Why should a company pay a higher

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interest on loan from a bank than what it gets from keeping money in the bank?

Generally, a company that pays dividend while maintaining a high level of debt on books is also a case for further investigation. Why should the company borrow on one side and repay back its owners on another? Moser Baer was one such company which fell 99% from its 2008 highs. Banks and NBFCs should generally be excluded from this tool of analysis as borrowings for these entities are a routine phenomenon.

INVENTORY VALUATION METHODS:

Companies that keep changing the inventory valuation methods between First In First Out (FIFO), Last In First out (LIFO) and Weighted Average Cost method should also be a subject matter of scrutiny. Inventory valuation should be as per the International Financial Reporting Standard (IFRS) and any attempt to move beyond the set standards of valuation should be viewed with suspicion. In the case of inventory valuation the auditor generally dusts his hands off by putting in a stereotyped comment 'as certified by the management' hence the audited books adds little weight to the absolute inventory figure even though the auditors do provide a note if the valuation methods are at variance with the set guidelines.

Pantaloon Retail used to value its inventory at selling price minus gross margin instead of taking it at the prescribed cost or realisable value whichever is lower. With each passing year the sales increased and so did the inventory leading to increased accumulation of unrealised gains from inventory overvaluation. As a holder of the stock, I spent a large part of my time worrying about the implications of this variance in inventory valuation. The reason why the markets ignored this valuation malpractice was because a) it was a bull market stock and b) the net effect on the profitability of the company was less than ₹200 crore. The implications of each of these accounting anomalies should be viewed in the context of their overall impact on the balance sheet. An impact of ₹20 crores on a company that makes ₹200 crores annually isn't as much a worry as on a company that makes ₹30 crore a year.

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It makes sense to work out all the accounting variances with the net effect on the profit and loss account instead of worrying about them in absolute terms and missing a potential multibagger.

Overall these red flags on the accounting standards are just guideposts or signals and are not any conclusive evidence of any wrongdoing. They just provide an investor with the smoke from where he has to look for the fire and unlike real life in case of companies as there are so many variables to analyse there can sometimes be smoke even without fire. Finally, if the company is a leading stock in a raging bull market then these things do not matter as much as they would once the bull market subsides, by which time the loss can be significant for an investor who did not move out on the first signs of trouble.

ACCOUNTING SINS ARE WASHED AFTER THE BULL MARKET ENDS:

Most companies keep committing these accounting sins for the entire period of the bull market to show higher revenue growth and increased profitability but as soon as the bull market ends they undertake huge write offs and adjustments to wash their dirty linen out in the public. *Most promoters and managers realise that if there is a bear market underway then even good results cannot take a stock up so the company thinks it better to synchronise its financials with the actual reality than to extend the fictitious profitability of the enterprise too much into the future.* This adds like a roller skates to stocks that are short on transparency and corporate governance and hence they fall much more during bearish times when compared to those companies who have followed a more transparent accounting policy all throughout.

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“Different opinions make a market but not all opinions make money!”

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Chapter 24

STOCKS TO AVOID

Knowing what not to do in the stock market is more important than knowing what to.

This chapter deals with stocks to avoid, but the flow of the argument extends a little beyond that and sometimes overlaps the topic of 'When to sell?' In the struggle to generate quick returns, the inexperienced investor refuses to realise that it is more important to avoid the potential losers than it is to pick up the prospective winners. *This is because a stock that halves in price needs to double up for the investor to break even.*

The specific attributes of stocks that an investor should look at avoiding even if comes at the cost of missing a profitable opportunity are enumerated below. It is essential to note here that as the stock market is an art and not a science an investor who has a disciplined method of investing will come across instances where his adherence to a strict set of self created rules will force him to ignore a clear cut money making trade but in spite of that an investor who knows what not to do will emerge as a winner in the long run over an investor who is always on the lookout for doing something.

LEADING STOCKS FROM THE LEADING SECTOR OF THE PREVIOUS BULL RUN:

One stock that every investor should look to avoid will be a company from a sector which was at the forefront of the immediately preceding bull run. Generally, investors are more keen to buy shares of companies that had participated in the immediately preceding bull run than they are in identifying the stocks that are starting to create a new trend. Change is the only constant in the market as the leadership changes with each bull run. Investors who bought ACC and other cement and steel companies after 1992 did not make

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any money because technology stocks led the next bull run and as investors lapped up Infosys after it receded from its highs of 2000 the market focused on retail, mobile telephony, construction and real estate stocks. *More investors bought Bharti, L&T and Unitech after they slipped from their 2008 highs than they did before 2008 when these stocks were making new highs. Somehow investors prefer buying stocks making new lows, on the way down than stocks making new highs - on the way up.* Post 2009, investors averaged out their losing trades in construction and real estate stocks while the party was in the consumer, pharmaceutical, IT Services and private financials space. *Leading stocks from the leading sector of the previous bull run can be bought only for a bounce but not for playing a trend. A stock that is down 95% from its all time high can always bounce back to double up but irrespective of that it will still be 90% off its highs.*

CHEAP SECOND LINE STOCKS IN THE LATER STAGES OF A BULL MARKET:

A cheap second line stock from a sector that is in a big bull run is also an avoid, more so when the sector has started to get hot from being warm earlier. Every investor thinks that the bargain which he is looking at will make outsized returns whereas in reality the relatively cheap second liners cause more wealth destruction on the way down than the sector leaders. Infosys is still up almost two times from its peak price of March 2000, while in the same period almost all the other software companies are below their 2000 high. In the construction space, only L&T can hit its 2008 price even while the probability of the same for other construction and real estate stocks look extremely remote though. So the next time a friend recommends a low P/E second liner of a sector in fancy, it would not be a bad decision to opt for the high P/E leader instead.

SMALL MICRO CAPS WITH UNTESTED BUSINESS MODELS:

A micro cap which hasn't proved its business model is another type of company to ignore. One way of doing so is to filter out companies that have not reached critical mass. The idea behind putting this filter of critical mass is because most small sized companies die a natural death without becoming large sized corporations and hence one should wait to see the business reach some degree of scale before jumping in to buy.

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Even in case of mid and large cap stocks there would be companies making losses but displaying an excellent potential for further gains in which case an investor would make surer gains if he buys after the company has turned around rather than in anticipation of a turnaround. A better strategy would be to buy a little at first and then aggressively add at a higher price on confirmation of a turnaround. *For an investor it is better to pay a little more when he is sure than buy at a discount when he is unsure.* Identifying a turnaround, is as much a matter of business analysis as it is about financial analysis. A company with a strong business model is more likely to turn around than a business with a weak economic set up. In case of weaker businesses the turnaround happens mostly when the complete sector turns around and not because of any specific attribute of the company in particular. For example if the steel sector recovers, all steel stocks would do well as the recovery would not be restricted to just one company. So trying to look for a turnaround also means looking at the broad industry dynamics rather than spending all the time doing an individual balance sheet research only.

STOCKS MAKING NEW LOWS:

Unless an investor is very sure about the prospects of a company, any stock which starts making 52 week lows for the first time is an avoid. If the company has already started to hit all time lows then the stock is an avoid for the moment and bargain hunting should be avoided till such time that the stock stops to fall (make new lows) and stabilises by getting into a sideways movement. Steep price falls do not generally result in high 'V' shaped recovery even though fallen stocks remain entitled for hard bounce backs all the time.

MARKET CAP IN RELATION TO THE SIZE OF THE SECTOR:

The excessively large market cap of a stock in relation to its sector can also make a case for avoiding the stock. At peak valuations, the market cap of the sector leader will try and get ahead of the entire industry revenue and at that point it will be clear that the company in question is trading on cloud nine. Consider the case of an Infosys in 2000 when it traded at a market cap

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to sales ratio of more than 100 and at that valuation Infosys's market cap matched the entire Indian software export market in revenue terms. On the other hand even though HDFC Bank trades at a market cap of over ₹160,000 crores the growth of the bank is predictable because of the excessively large size of the banking industry. Compared to this the market cap of Bharti Airtel in 2008 at over ₹200,000 crores was just too large in relation to the size of the entire telecom industry.

COMPANY MAKING LOT OF ACQUISITIONS:

Another type of company to avoid is the one which makes a lot of acquisitions. An acquisition is never cheap and the growth which comes from acquiring other companies is generally RoCE dilutive when compared to the growth that the company generates on its own. Most companies that are on an acquisition spree fund these purchases by taking on debt which puts them in a vulnerable position when the cycle turns as it is generally difficult to make a lot of money from a business acquired with borrowed capital. A company that acquires a lot of new assets accepts that it sees little scope for growth in its existing business, a signal that should well be understood by existing investors.

COMPANIES GETTING INTO UNNECESSARY DIVERSIFICATIONS:

A management that is undertaking a lot of new unrelated projects is one to avoid right away. Past history suggests that investors make more money from companies that are focused on a particular line of activity than on one which are on a diversification spree. CESC's move to get into grocery retailing through Spencer's looks as strange as India Cement's foray into buying the Chennai Super Kings cricket team and while there might be an odd money making opportunity most of the time these attempts to get into unrelated activities backfires on the main business. Deccan Chronicle Holdings Ltd (DCHL) spent ₹61.2 crores to buy out Odyssey, the leisure, retail and book store chain which had a revenue of just ₹20 crores. Subsequently, DCHL bought out the IPL cricket team 'Deccan Chargers' for $107 million in January 2008, just when the bull market had hit its peak. These unrelated diversifications had cost the company dearly as it quickly slid towards bankruptcy a few years after making these unrelated diversifications.

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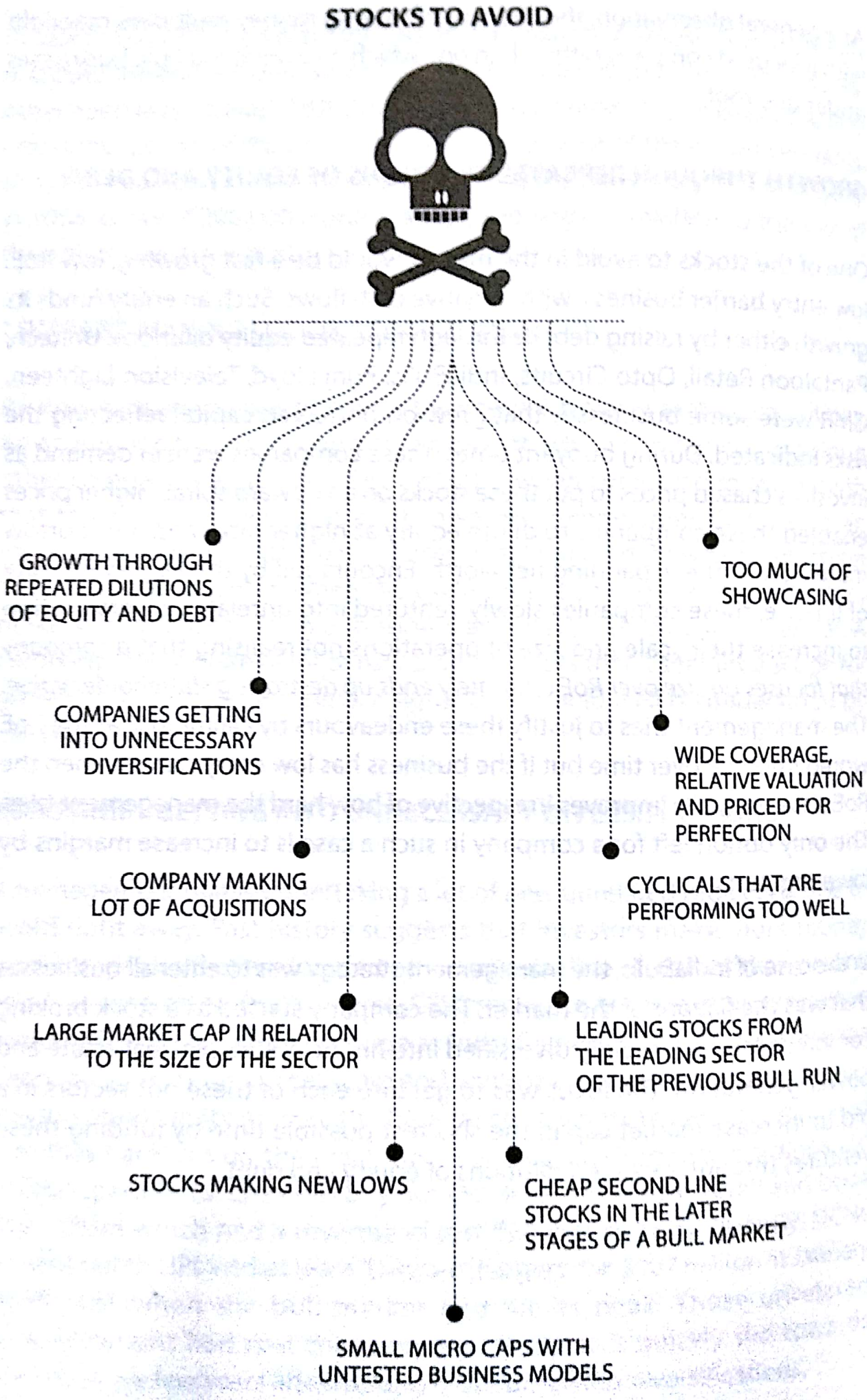
As a general observation, the chances of making money multiplies manifold with a focused company rather than one which is running multiple businesses under one roof.

GROWTH THROUGH REPEATED DILUTIONS OF EQUITY AND DEBT:

One of the stocks to avoid in the market would be a fast growing, low RoE, low entry barrier business, with negative cash flows. Such an entity funds its growth either by raising debt or through repeated equity dilutions. Unitech, Pantaloon Retail, Opto Circuits, IndiaBulls, Punj Lloyd, Television Eighteen, GMR were some businesses that grew on borrowed capital reflecting the risks indicated. During buoyant times, these companies were in demand as investors chased prices to put these stocks on an upward spiral. Higher prices enabled these companies to dilute equity at higher rates and also borrow more against the expanding net worth. Encouraged by the easy availability of finance, these companies slowly ventured into unrelated diversification to increase their scale and size of operations not realising that *a company that focuses on size over RoE ultimately ends up destroying shareholder value.* The management tries to justify these endeavours by claiming that the RoE would improve over time but if the business has low entry barriers then the RoE never actually improves irrespective of how hard the management tries. The only option left for a company in such a case is to increase margins by lowering costs.

In the case of IndiaBulls, the management strategy was to enter all businesses that was the flavour of the market. The company started as a stock broking company and then rapidly diversified into financial services, real estate and power generation. The focus was to get into each of these hot sectors in a bid to increase market cap in the shortest possible time by funding these ventures through repeated dilutions of equity and debt.

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When the cycle turned with hardening interest rates, the capital intensive nature of these businesses demanded further fund infusion which seemed harder to come by because of the deteriorating economic environment. Any company which grows through external funding (raising equity and debt) instead of internally generated cash ultimately puts itself and its shareholders under financial distress and the same was the case with these stocks that were expanding business through repeated dilutions of debt and equity.

When a company grows at rates higher than its RoE it encounters what is called a funding gap. Generally, these type of companies thrive in a bull market and hence the management fills up this funding gap by issuing shares and also by taking on debt. Issuing shares does not create any permanent obligation on the company because a shareholder is entitled only to dividends which in any case is dependent on the profitability of the company and the discretion of the management. *Raising equity is relatively easy in the bull market as more often a stock finds buyers just because it is expected to sell for a higher price tomorrow against what it is being transacted for today.*

The democratic way of raising fresh equity is through a rights issue which gives the existing holders a right to buy further shares in the company. As raising money through placement to institutions and mutual funds is less cumbersome when compared to a rights issue, companies occasionally raise capital by making placements to Qualified Institutional Buyers (QIBs). As these shares are issued at a slight discount to market price the focus of these buyers remains on pocketing the discount by selling the shares in the open market as soon as they are allotted. Thus in one way, a (QIB) creates fresh supply of the stock for any large buyer who would have otherwise bought the shares from the open market by positively influencing the price.

Personally, I rode this growth theme quite well between 2003 to 2008 betting on Pantaloon Retail and Television Eighteen. Both these companies were growing quite rapidly for their means through repeated activities of fund raising. While it was clear that these companies were skating on thin ice the high revenue growth with the expansion plans of these two companies remained the star attraction for investors to put in their money. *Sometimes when an investor is young, his ignorance works to his advantage as he focuses on price, revenue and earnings growth without putting too much emphasis on*

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the other financials of the company. However, if he is not smart enough to exit these stocks at the right time and the fact that he has bought them is an indication that he might well not be, then the price retraces back to the point from where it had begun its upmove - very quickly.

As I mentioned above, I stayed invested in these two stocks for a variety of arguments but the primary reason was that these stocks were in demand and the revenue and earnings growth were too robust to be ignored. *As market participants our understanding grows with time, sometimes not knowing enough is a boon whereas in another phase not knowing enough could be a curse.* An investor should stick to his original thesis for example if he has bought the stock because the company has been growing fast he should seriously look at liquidating his investments the day he thinks the growth to be coming under threat instead of looking at his purchase price and then thinking about giving the company some more time to re-establish itself back on the high growth path. *A company that slips from its high growth trajectory almost never ever changes direction to grow fast again.* As I was obsessed by growth I bailed out on the first signs of growth slowdown even while many others waited for the company to go back to its high growth days and the stock to reach to its old levels again.

Moreover, if the company grows its debt at a rate faster than or almost equal to the growth in revenues over a three to five year period then it is a case of potential financial distress. This financial distress does not occur till the time these companies have access to easy debt in a low interest rate environment but starts as soon as the bull market ends and interest rates rise. A few companies that have over the past few years grown their debt along with the sales are Pantaloon Retail, Punj Lloyd, Opto Circuits, Nagarjuna Construction Company, HCC, IVRCL and Gitanjali Gems all of which are down 90% from their all time highs of 2008.

CYCLICALS THAT ARE PERFORMING TOO WELL:

Another stock to avoid is a cyclical stock after it has had a string of good results. By definition, a cyclical is supposed to move in a cycle so the good and bad times are replaced by each other sooner than what the market

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expects. Cyclical stocks report record earnings and huge expansion plans when the cycle is in full swing and report losses with curtailment in expenditure when the cycle is nearer to the bottom. *Clearly investors need to be taking money off the table when the going is good and putting in their stakes when the going is bad which is quite the opposite of what the normal man is comfortable doing.*

WIDE COVERAGE, RELATIVE VALUATION AND PRICED FOR PERFECTION:

Another set of companies to avoid are companies with wide institutional coverage and priced for perfection. A company expected to grow at 30% and trading at a trailing P/E of 30 times would generally appear to be an avoid but the quality and predictability of growth is more important than the valuation. Let us consider two companies one from construction and another from the consumer space, trading at a P/E of 30 and expected to grow at 25% each for the next few years. Here the company from the consumer space will more than likely be able to grow at 25% because a) it would have entry barriers with pricing power to its business and b) it's products would be more essential in nature. On the other hand, a construction company suffering from cut throat competition will face a tougher challenge to grow at that rate and hence the stock to avoid will be the one from the construction space.

Consider a company which is not a part of an overall sector led bull run, growing at 40% and trading at a P/E of 40 times on trailing earnings. Assume further that this growth is more likely to taper down to 25% in the next five years, so if the stock is quoting at ₹300 for an initial EPS of ₹7.5 and keeps growing at 40% for five years the EPS at the end of year 5 will be ₹40.34 and if the stock sees a P/E of 25 times the price of ₹1008 would have generated a 27.44% CAGR for the five year period. This return is being generated assuming a stupendous 40% earning CAGR for five consecutive years and a 25% CAGR thereafter.

An investor, who can alternatively get a 20% to 25% annualised return betting on a stable compounding stock will be better off than betting on this high growth stock. However, if this high growth stock is a free cash flow generating

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company that pays dividends at an increasing rate and is engaged in a business with strong entry barriers then one can stay with this 40% grower even at a 40 P/E because the free cash flow will help the company declare and increase the dividend at the end of each year. This would help support the price while the strong entry barriers would facilitate the growth over the five year period.

If two investment options are potentially providing an equal set of returns it pays to back the one with lesser risk.

When the market size is large and expanding, the companies in that industry find ways to grow at above average rates for longer periods of time. Sometimes the management pedigree and operating history also helps an investor in predicting the growth profile of a business. HDFC Bank is one such name which in spite of being widely owned and followed by most institutions has managed to grow at around 30% CAGR for the last several years. Each quarter there are a bunch of analysts and brokerages who come up with a cautious note on how well this growth has been priced in by the market. Inspite of this, the bank continues to trade at valuations which are not too ahead for its growth profile on a P/E basis. Moreover, it is easier for a business to generate growth by capturing market share from other players as is the case with these private banks and the Non Banking Finance Companies (NBFCs) than it is by expanding the market pie as it is with the construction and real estate companies.

TOO MUCH OF SHOWCASING:

The management of a company which does too many conference calls, analyst meets and investor presentations should be avoided. These companies share all the possible positive aspects of their business with the analyst community thus leaving the stock devoid of any potential surprises. *A guidance puts the stock for no reward on a hit and plenty of risk for a miss* as markets don't like companies that keep going back on their word. When a management is put under analyst and peer group pressure of showing the right numbers it resorts to cooking books and cutting corners so as to ensure that the results match the preconceived expectations that it has set for the analyst and shareholder community.

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On the other hand, companies that do not issue guidance nor do conference calls are not preferred by the analyst community as it is easier for an analyst to save his skin if a company misses its own guidance than it would be for him to justify his recommendation if a company fell short of the estimates that he had personally prepared for it. *The big money is made by companies that do not provide guidance and estimates, as markets pay for sudden surprises than for known expectations.* Once the stock price moves up and the company becomes popular it starts doing conference calls and investor meets thus removing the surprise element from the stock which then dilutes the future gains. A company that does not conduct a conference call would generally be unpopular as a conference call would be conducted only when some brokerage agrees to sponsor it and no brokerage sponsors a company that is not in demand.

Overall, each investor should have a list of stocks to avoid depending on his level of competence and his own set of preferences. Sometimes, an investor might just avoid a stock because it does not confirm to his ability of understanding, which is perfectly normal. Many investors ignore the pharmaceutical space because the internal industry dynamics of the space is beyond their level of comprehension but that has not deterred them from making super sized returns from the market. *While it takes eleven players to make a cricket team compulsively divided between batsman, bowlers and a wicketkeeper making money from investing has no such compulsions as an investor can either ignore a certain type of player or fully rely on another.*

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“Ninety percent of money managers, with long term stock holdings spend 90% of their time, debating on the next 10% market move.”

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Chapter 25

DRIVERS OF A P/E RATIO

If Price Earnings to Growth (PEG) is such an important valuation matrix why aren't companies growing at zero percent available for free.

The Price to Earnings (P/E) ratio of a stock forms an integral part of its valuation matrix and varies across sectors and companies. The P/E ratio is influenced by a host of factors ranging from company specific financials, management pedigree, overall market mood, size of the company and interest rates. A young investor in his early years of study generally differentiates a P/E ratio based on absolute numbers and erroneously mistakes a high P/E for a stock that is ready to come down and a stock with a low P/E as one that is eager to move up, a thought that is challenged most of the time he attempts to convert his theory into practice.

Very few people can predict the P/E ratio of a stock and most estimates of the P/E ratio are made by extrapolating the current P/E into the future. It is also a misconception that people who buy low P/E stocks are value investors whereas those who buy the high P/E ones are the reckless speculators. This is because the intrinsic value of a stock is not based exclusively on the P/E ratio but is the discounted value of its future cash flows and though a low P/E ratio optically indicates a higher value it does not provide any conclusive evidence on the same because the higher valuation could also be based on a high earnings flow in which case the stock gets cheaper with each passing year. Just as perceptions keep changing the P/E ratio of a stock keeps moving up and down bouncing up in times of promising conditions and tumbling down in times of challenging circumstances. Overall, the P/E continues to be influenced and determined by various factors many of which are listed below:

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GROWTH RATE:

The popular method of identifying the P/E ratio is to equate it with the growth rate of the company. *Generally, earnings growth refers to EPS growth and not the absolute net profit growth but markets prefer to pay for sustainable revenue growth which is a more robust indicator of a trend as earnings growth can be manipulated by following various accounting methods and practices.* The method of equating the growth rate with the P/E is referred to as the PEG ratio and indicates that the P/E of a stock should equal the earnings growth rate of the company. For instance, a company growing at a compounded rate of 20% should have a normalised P/E ratio of 20 times. If the P/E of this 20% grower is more than 20 than the PEG would be more than one and considered expensive whereas if the P/E of this company is less than 20, the PEG would be less than one and considered cheap.

Every bull market has its own poster boy, the growth stock that starts from a cheap valuation and gets expensive. The process of this leading bull market stock getting expensive by an abnormal P/E expansion continues till the bull market is in vogue and equating the P/E with the rate of growth works best only in times of a raging bull market. However, this method suffers from over simplification as the P/E ratio is an outcome of various factors and not just the growth rate. *While equating the P/E to the growth is a reasonable assumption it represents more of a tendency and less of a formula. The P/E and the growth rate of the company have a strange relationship that overpays companies that grow fast and penalises those corporations that do not grow at a reasonable pace. A company that grows at 15% would trade at a P/E of 12 whereas a company that grows at 30% is bid up to 35 times earnings.* The logic for the P/E of a low growth company to be less than the growth rate and for a high growth company to be traded at a P/E of more than the growth is because while there are many companies growing at 15% there aren't too many 30% growers around because of which the market pays scarcity premium for growth.

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ENTRY BARRIERS:

Companies that operate in industries having barriers to entry are given a higher multiple than the ones operating in an environment having no barriers to entry. *The longevity of a business is directly correlated to its ability to enhance its barriers of entry either by having a blockbuster product or by repeated innovations to existing product lines so as to maintain the difference whether perceived or actual with that of its nearest competitor.* Having a barrier to entry assures the company of making consistent and predictable long term profits. It is with this premise that shares of consumer and pharmaceutical companies trade at a higher P/E in comparison to stocks of companies from sectors such as cement and steel.

SUSTAINABILITY OF EARNINGS:

As the P/E ratio discounts the current earnings to a certain price, companies that have predictability and sustainability of such earnings will get a higher valuation than companies whose earnings cannot be forecasted with any degree of reasonableness. *A company that can be safely forecasted to grow at 20% for the next ten years will generally be valued at a higher P/E than a company that cannot be forecasted to grow at 40% for more than one year.* Markets provide disproportionate rewards to companies which can promise years of

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OPERATING HISTORY:

The stock market is a game of trust where companies with a longer operating record of robust earnings get a higher P/E compared to businesses with limited history. A longer operating history creates confidence amongst the investing public about the company's ability to handle the ups and downs of business cycles. As argued above the P/E ratio is not just a function about the current growth phase but is also a function of the sustainability and predictability of future growth and one of the best indicators of the future is how the company has conducted itself in the past. It is with this logic that shares of a HDFC Bank or MRF tend to fall less in times of a downturn when compared to their peer group stocks. The market finds it easier to place trust in these companies as these companies have demonstrated their resilience from the past business cycles to handle themselves in times of an economic downturn. If the company does not have a robust operating history then an investor should seek to look for a catalyst of change, before investing.

DIVIDEND YIELD:

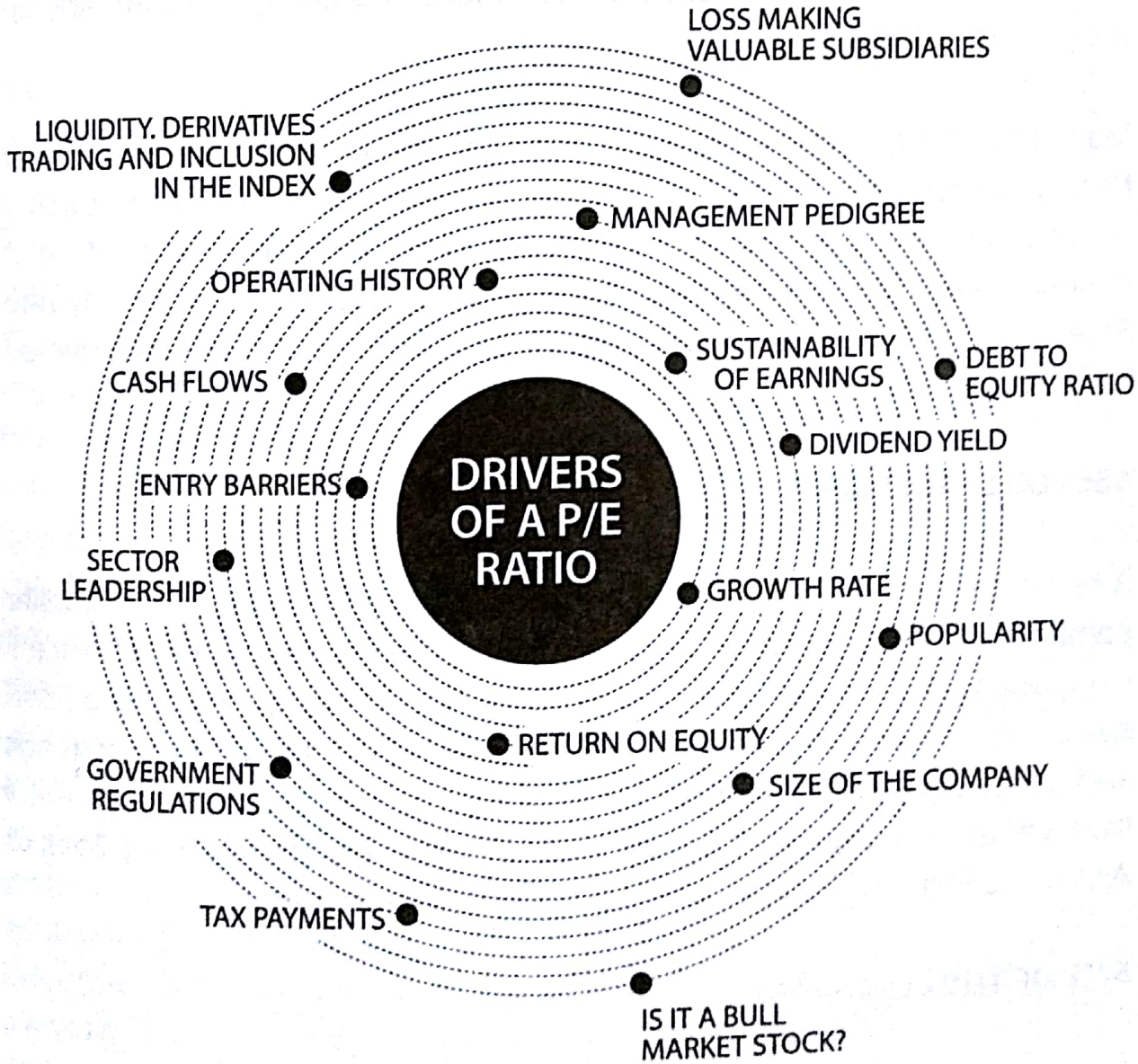
Market loves dividends and companies that give out large dividends get a higher P/E when compared to low dividend paying companies. Sometimes a stock trades at a higher valuation because of its dividend yield and hence the resultant P/E number gets an optical expansion. For instance, a company generating an EPS of ₹10 and having a payout of ₹8 per share could trade at a yield of 2% at ₹400 at which price it would discount its earnings 40 times. Assuming the growth to be 20% the stock would appear expensive on the basis of its growth but if one were to equate the growth with the P/E then the price of ₹200 (EPS of ₹10 x P/E of 20) would make it a 4% yield stock at which price not too many people would be willing to sell a 20% grower.

CASH FLOWS:

Sometimes the P/E of a stock is also determined by the cash flow nature of the business. A business that generates free cash flow will trade at a higher P/E than a business which is cash flow negative. Cash flow is an offshoot of low capital expenditure and negative working capital, attributes of which

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are found in most of the consumer, IT Services and pharmaceutical companies. A business generating free cash flow will have a surplus to be distributed as dividends amongst its shareholders and hence the price will also be influenced by the current and prospective yield of the stock. A company that does not throw back regular cash from operations will be repeatedly raising debt or issuing shares, both of which act as gravity to the stock price. The free cash flow test should not be employed to companies from the financial services or the commodity cyclical space.



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MANAGEMENT PEDIGREE:

Companies managed by an efficient, honest and transparent management generally get a higher discounting from the market. If a company's accounting system is assumed to be clean and conservative and the group has a history of upholding the interest of the minority shareholders the stock will command a higher P/E multiple for every rupee of earnings generated. Accordingly an established promoter generally commands a higher multiple when compared to a new and unknown management. However, being honest and transparent isn't enough for creating shareholder gains as a management also needs to be effective and efficient in executing its plans and taking the company up the growth ladder.

Many might argue for putting the management pedigree ahead of other factors for determining the P/E ratio but in reality the management quality is subordinated by the quality of business as evaluated from the nature of dividend payouts, cash flows and entry barriers. This also explains why Tata Steel and TCS do not trade at the same P/E multiple in spite of being owned by the same promoter group.

SECTOR LEADERSHIP:

A sector leader will always be valued at a P/E higher to that of its smaller competitors. Many of these arguments are interconnected for instance a company that is a sector leader will always have a higher critical mass and size while companies with free cash flows will distribute higher dividends and hence qualify for a higher discounting. It is with this reason that TCS trades at a P/E higher to HCL Tech; HUL to Jyoti Laboratories; HDFC Bank to Axis Bank; Page to Lovable or an Asian Paints to a Berger.

SIZE OF THE COMPANY:

Larger companies having reached a critical mass get a higher P/E compared to their smaller peers. *It is more difficult for a large sized business to fail than it is for a small sized one.* As companies increase in scale and size they trade at higher multiples when compared to when they were small.

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GOVERNMENT REGULATIONS:

Companies that are subject to a lot of government interference and regulatory control generally find it hard to be valued at a higher multiple as such companies find it difficult to grow at a steady rate. This argument overlaps with the aspect of growth and predictability of earnings as discussed above because anything under government control cannot be assumed to be growing with predictability over longer periods of time.

POPULARITY:

Stocks that are popular tend to trade at a higher P/E when compared to stocks that are unpopular. One of the biggest inferences of the popularity of a stock is the number of shares it trades each day. A stock that trades thinly indicates lesser public participation compared to a stock which experiences brisk trading activity. A low trading activity also indicates that the owners are mostly long term holders in the stock with little interest in engaging for short term trades. Another indication of a popular stock is the frequency with which the management conducts investor meets and conference calls. The management of a popular stock will also be more visible on the electronic and print media explaining its future plans with a view to creating investor interest for the stock. An investor who intends to make large sized gains should buy a stock before it becomes popular because even though investor confidence increases with popularity, the quantum of potential gains diminishes as a stock becomes popular. However, just because a stock becomes popular does not mean that its owners remain restricted for above average returns. The HDFC group remains one of the most popular entities in India and yet its shareholders continue to generate above average returns. While it is prudent for investors to resist popular stocks the key aspect to look out for is whether the popular stock is reasonably priced or exorbitantly overpriced. *A shareholder's right to make returns isn't governed by the popularity of a stock as much as it is by the ability of the company to deliver a steady state of earnings growth for a given level of valuation.*

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LIQUIDITY, DERIVATIVES TRADING AND INCLUSION IN THE INDEX:

As a stock gets popular it gets liquid and is introduced for derivatives trading under futures and options and becomes a part of the leading indices like the Nifty and the Sensex. Such an inclusion enhances the visibility of the stock as there are many mutual fund schemes, whose investments are governed only on the basis of whether a stock is a part of a certain index or not. A stock that is a part of the index and is allowed for derivatives trading will see a higher P/E when compared to any other company.

TAX PAYMENTS:

Companies that pay full taxes are assigned a higher P/E ratio when compared to companies that don't come under the full tax bracket. Similarly, companies that enjoy excise and sales tax benefits are generally valued at a lower multiple. This is because the P/E reflects the stock price based on current year earnings whereas the fair value of a stock is the present value of its discounted future cash flows. The lower tax rates will slowly change over time as sooner or later all companies will have to come under the tax bracket and though the company may take price increases to offset the same its P/E ratio will not reflect the growth profile and other parameters as it does for a full tax paying company.

Kaveri Seeds and Bajaj Corp are two stocks that are valued at a P/E multiple which appears to be optically lower because these companies enjoy tax breaks in their own way. Comparing a full tax paying company with another company that does not pay taxes might not be an apple to apple comparison as a change in government policy or the termination of the subsidised tax regime could subject them to full taxes as the valuation seems fair when looked at on a profit before tax basis.

DEBT TO EQUITY RATIO:

Debt free companies have a higher P/E when compared to companies that have a lot of debt sitting on their books. This is because while the market cap provides an idea of the total market value of owners capital the value of

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the business is determined by the enterprise value which is computed by adding the debt to the market cap. *An acquirer of a debt free company gets access to complete ownership by purchasing the entire equity from existing shareholders.* However, if the same buyer is forwarded a proposal to bid for a company which is laden with debt he would have to fork out the market cap and also assume liability for the debt standing on the books. The rights of these lenders run unrestricted to the extent of debt that has been taken from them and hence ownership of the company would not be complete unless the debt holders are extinguished in full. The valuation for the equity component of the capital structure for a debt free company would therefore be higher than what it would be for a company that makes equal amount of net profit by employing debt. A higher valuation for equity indicates a higher P/E ratio and hence companies that are debt free tend to be valued ahead of those companies that have a larger debt on balance sheet.

LOSS MAKING VALUABLE SUBSIDIARIES:

Companies with embedded value of businesses that are not making a lot of money at present but expected to make decent returns in future appear to be valued at a high P/E ratio. This is because the P/E ratio is derived by dividing the price with the EPS whereas the price is inflated with the value of the business that isn't contributing to the EPS for now and hence these stocks always look expensively valued. Kotak Bank is one stock that has moved up 40 times from 2003 to 2013 but has always had a higher P/E because of its valuable insurance subsidiary which isn't contributing to profits as of now but still has to be valued for its prospective earnings because a business that is not making money cannot be marked down to zero!

IS IT A BULL MARKET STOCK?

Irrespective of all this, in times of a raging bull market the fancy of the sector supersedes all other aspects of valuation as in a bull run stocks are valued mostly on the basis of growth. Under such circumstances, free cash flow, dividends, management pedigree, operating history takes a back seat as investors focus on whether the company is going to grow fast or not. Companies that can grow faster are bid up as long as the growth continues.

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In the year 2000, Infosys was assumed to retain its 100% growth year on year for the next several years which when put in a mathematical tool converts an investment of ₹100,000 to ₹10.24 crores over a ten year period. *In the market emotions supersede reasons and there is no bigger emotion driver than the prospects of above average period of supernormal growth.*

A fast growing business brings back valuations to reasonable levels, a company growing at 40% CAGR available at a P/E of 60 times earnings will be 43 times for the next year; 31 times for the following year and just 11 times five years down the road. However, a stock that is slated for a 40% growth for five years hits an air pocket sooner than what most analysts think and causes a collective financial damage more than what most investors can afford to handle.

In the next chapter we discuss the circumstances that cause the P/E ratio to expand and contract with case histories from the past.

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P/E EXPANSION VS. P/E CONTRACTION

A high P/E stock with strong barriers to entry is a compounding machine; a high P/E stock without barriers to entry is a potential disaster – waiting to happen.

The price to earnings ratio of a stock is a perception of its future earnings. A company that trades at ₹150 for an EPS of ₹15 and a P/E of 10 may suddenly go to ₹1,480 if the EPS growing at 35% for three years moves to ₹37 and powered by the higher growth, the P/E ratio also expands to 40 times. The increase in P/E from 10 to 40 is called P/E expansion which is a process of trust and faith built by the market in the backdrop of increasing growth perception, about the company to deliver earnings at an increased rate for longer periods of time.

HIGH P/E SUSTAINS ITSELF FOR THE ENTIRE PERIOD OF HIGH GROWTH:

Once *the P/E expands beyond the stated levels of revenue growth the stock price borrows a little from the future and stays at a high P/E as long as the company can keep its investors convinced about the enhanced levels of growth delivery. The P/E ratio is patient with a stock that promises to grow as much in the future as it has in the past and rerated stocks don't get derated unless the growth momentum slows down.*

There is far too much money in this world to let go of a fast growing company that seems valued just ahead of current year earnings, so if a company growing at 35% gets valued ahead of its current earnings the stock tends to stay in a range till such time that the price reflects the higher growth profile. This happened to HDFC Bank in the year 2000, when the stock price stayed

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in a tight band for three years as its P/E went up to 45 times earnings, it happened to Jubilant Foodworks and Titan industries in 2011 when these stocks entered a sideways movement, it happened to Gruh Finance in 2013 as the company's stock price took a breather after the stock moved up 175% from ₹90 in July 2011 to ₹250 in January 2013 when the market re-rated the stock to a P/E of 30 times current year and a price that was at more than 9 times its book value.

The phenomenon of companies borrowing from the future to maintain their current state of extended valuation is a privilege that the market grants to high quality companies with predictable earnings growth and not to inferior businesses with a volatile earnings trajectory. For companies having an inferior business model with little barriers to entry the market pushes down the price so that the meeting point between valuations and earnings even though painful to existing investors is faster. It is difficult for mediocre businesses to sustain new competition and maintain increased earnings growth over longer periods of time and hence the market is a little reluctant to keep it overvalued for longer periods of time. Once the stocks are valued ahead of current earnings the price waits for the new earnings to accumulate, and the stock price moves up as soon as the overvaluation is negated by the enhanced earnings flow.

When a company grows quickly at an above average rate its P/E becomes sticky and in most cases keeps expanding for the entire length of the high growth period. This P/E expansion for leading bull market stocks growing at above 35% CAGR happens at a faster rate and moves beyond 40 whereas for companies growing at below 35% CAGR the P/E stops expanding after reaching the growth button. *Irrespective of valuations an investor's tendency to look for super high growth opportunities far exceeds their appetite to remain satisfied with the moderate growth options.*

P/E CONTRACTION:

When a company generates above average growth for longer periods of time it reaches a stage where its own size becomes an enemy and it faces challenges from market saturation, competition, product obsolescence or any other reason that threatens to cause a reversal in the underlying growth fundamentals. More often than not the market acts in anticipation, as the fall in the stock price happens before the company's growth rate actually

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drops. So a company might start to see its price come off even while the profit growth might continue uninterruptedly for the next couple of quarters.

P/E expansion beyond a point is like borrowing money from a neighbour to enjoy a Sunday picnic. Sooner or later, that money has to be returned back.

Consider our stock earlier which was trading for ₹1,480 at a P/E of 40 time. for an EPS of ₹37 and growing at 40% year on year. In this case, if the market gets a sense that instead of 40% the company will now grow at 25% only then the P/E will fall from 40 to maybe 20 times. Markets work on sentiments, so even though one can argue that the P/E should fall to 25 the reason is markets overshoot both in times of optimism and pessimism. Therefore, while the EPS would increase by 25% to ₹46.25 a P/E of 20 would push the stock down to ₹925 which would be a drop of 37.5% from the peak price of ₹1,480.

In spite of an increase in EPS, the price falls because the stock has experienced a P/E contraction which happens only when the growth perception of the stock deteriorates from what was prevailing earlier. Most of the quick money in the markets are made and lost by P/E expansion and P/E contraction only.

SMALL MARKET CAP COMPANIES ENCOUNTER TIME CORRECTION:

The leniency of the market to provide time for earnings to catch up is also dependent on the market cap of the company. In cases where the market cap is small in relation to the scale and size of opportunity and the company can demonstrate its ability to grow uninterruptedly, the P/E ratio refuses to fall because investors foresee years of long term earnings growth which causes the price to hold itself rather then fall precipitously.

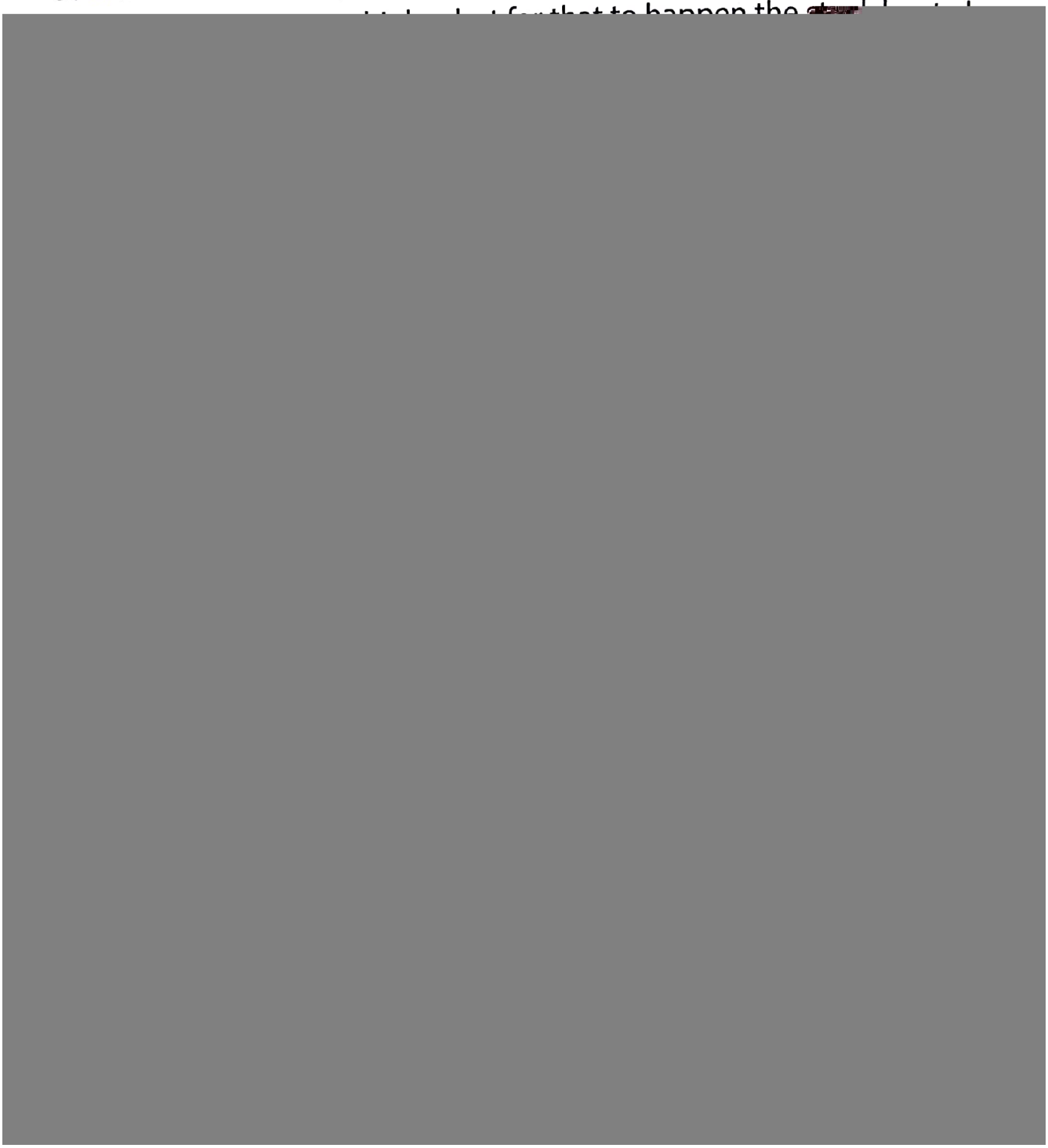
P/E EXPANSION LEADS TO MULTIBAGGERS:

An investor looking for a multibagger has to just identify a compounding powerhouse with a potential for P/E expansion as the P/E expansion remains the real driver of return. Most compounders were initially multibaggers which after an increase in the P/E ratio started generating a return only to the extent of increase in earnings. In my initial years of investing I never had a clue on what the swings in the P/E ratio could do to total investor returns as the P/E

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seemed to be an absolute number which either appeared to be too high or too low. I never understood enough of it to get a sense of the swings in the P/E ratio, a phenomenon that I was later introduced to when in the aftermath of the technology bubble I almost lost my entire portfolio as a result of mindless leveraging in inferior quality stocks.

The triggers for a P/E expansion are rising EPS and a growth in sales. As a rule of thumb, markets try and equate the P/E to the level of sales growth even though the P/E is influenced by other factors also. A company that is increasing sales at a CAGR of 35% will see a P/E level of up to 35 while sometimes this P/E expands to two times the sales growth so in this case it



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and starts conducting conference calls, roadshows and other investor awareness programs to sell its booming growth story to both current and prospective investors. Promoters get interested in the market cap which is a sign of strength in the corporate world and the company from being traded at a trailing P/E gets justified on the basis of a forward P/E under such circumstances a stock that was trading at a P/E of 20 times trailing is suddenly valued at 30 times forward. So one trick to make a lot of money in the market is by buying a stock which was a slow growth company in the past and is now on the threshold of being a high growth company though this is more of an exception rather than the rule as *unless there is a structural change, slow growth businesses don't grow faster on their own - just as a zebra with black stripes, in spite of all its efforts, cannot become a cheetah with black spots.*

MAKING AND LOSING THE BIG MONEY:

The P/E expansion as indicated earlier is one of the cornerstones to making the maximum amount of money from the market in the shortest span of time. On the other hand, P/E contraction remains the route to losing the maximum amount of money in a stock in the shortest possible time. The P/E expansion effect gets accentuated as both the earnings and the P/E rises at an increasing rate whereas in case of P/E contraction its only the P/E multiple which contracts whereas the earnings may still be rising but at a decreasing rate. So when a 50% growth company drops to the 20% to 25% growth range its P/E ratio tumbles a lot more than the increase in earnings leading to a deep slump in prices.

INFOSYS:

During the technology boom all software stocks experienced an unprecedented P/E expansion but Infosys the leader of the group saw its P/E expand 19 times, from 16.9 times trailing in 1996 to almost 322 times at the peak in March 2000. The P/E expansion was supported by a super normal revenue and EPS growth as investors bought the stock assuming the growth to continue for a longer period of time from what it actually did. When the bubble burst in March 2000, all tech stocks plummeted and so did Infosys and for a company that was doubling EPS every year the real brake came in

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April, 2001 when Infosys revised its revenue growth guidance downwards to 30%. But by this time, the markets had already pushed the stock down 70% from its March 8, 2000, all time high price of ₹1,726. As the Indian technology boom was a subset of the overall NASDAQ move, the fall in Infosys continued unabated as new buyers rushed in to buy at every downtick even as the smarter ones exited the stock. The P/E finally contracted to 18 times by September 2001, causing a resultant price damage of about 80% from its all time high price of March 2000.

When the price fell, the stock which looked expensive for the entire length of the bull market was in demand from small uninformed investors as each lower price tick increased the optical attractiveness of the stock when viewed in the backdrop of the higher prices of the past.

A look at the number of shareholders shows the story. Participation from shareholders was restricted in the initial years of growth while the momentum picked up just before the stock hit its all time high. The number of shareholders jumped five fold to 46,314 in 2000 from 9,527 in 1999. From 2000 to 2001 the number of shareholders exploded to 89,643 while the stock collapsed 70%. *Infosys is just a representative sample. The reality is most people enter a bull market stock after it starts descending from the top rather than when it is on its way up.*

On the other hand, there is no need for an investor to buy a stock at the bottom as buying a bull market stock isn't as much a losing deal if an investor buys it even after the stock has moved up a lot from its bottom as is evident from the table below. However, when it comes to selling, the same investor has to be nimble footed and sell on the first signs of trouble which will be evidenced by the initial signs of slowing growth. *An investor in Infosys would have done fine if he had bought the share even three years after it made its move but it was time to move out of the way quickly, once the stock had hit its peak and was on its way downhill.*

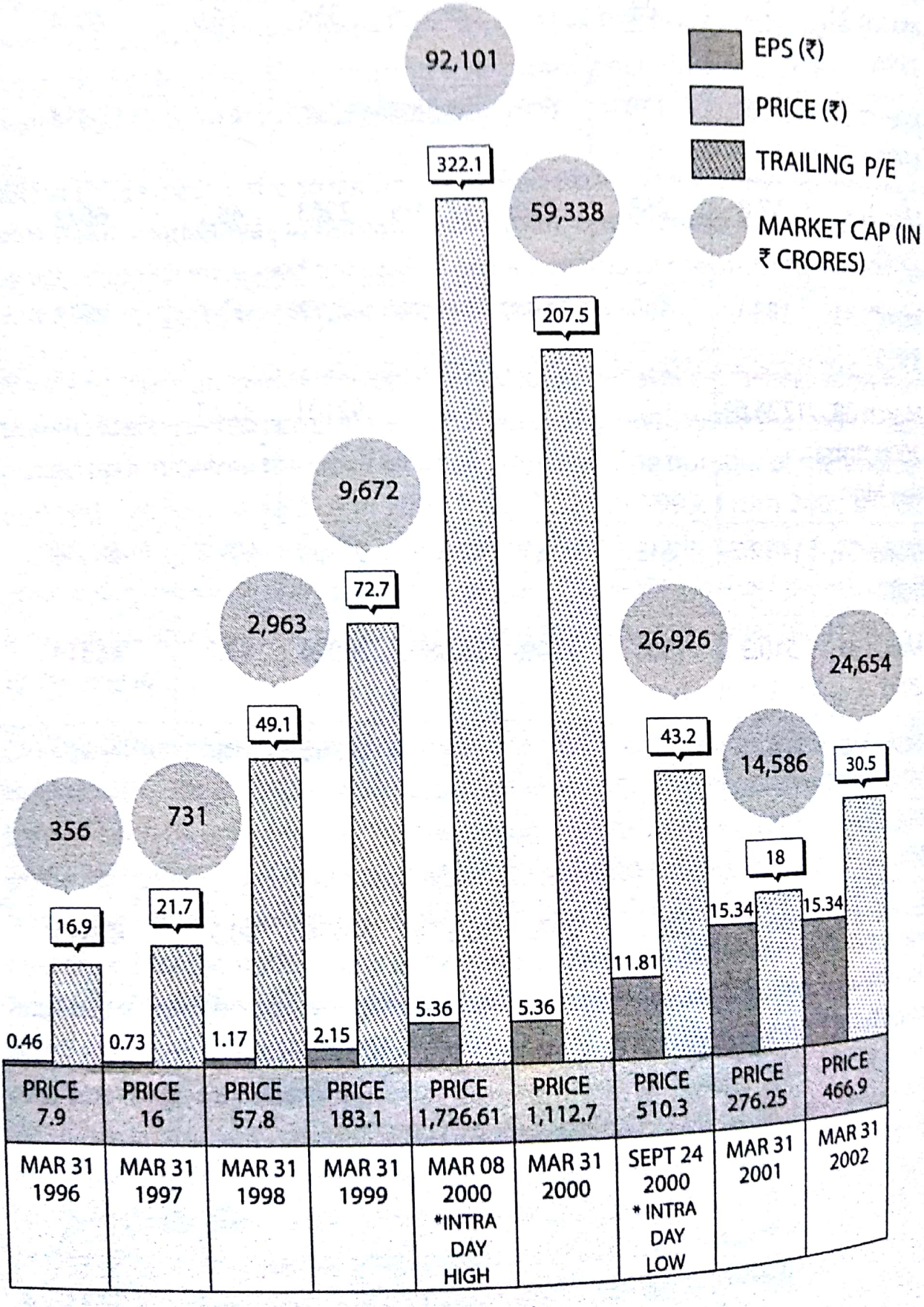
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INFOSYS - P/E EXPANSION AND CONTRACTION

Year	Price (₹)	Revenue (₹ cores)	Profit Growth	RoE	Market cap (₹ crore)	Trailing P/E	No. Of Shareholders
March 31, 1996	7.9	88	-	29.53%	356	16.9	6909
March 31, 1997	16	139	60%	34.76%	731	21.7	6414
March 31, 1998	57.8	258	79%	42.24%	2963	49.1	6622
March 31, 1999	183.1	509	119%	54.16%	9672	72.7	9527
March 08, 2000 *intra day high	1726.61	–	–	–	92101	322.1	-
March 31, 2000	1112.7	882	115%	40.83%	59338	207.5	88650
March 31, 2001	510.3	1901	118%	56.08%	26926	43.2	46314
September 24, 2001* intra day low	276.25	–	–	–	14586	18	-
March 31, 2002	466.9	2604	29%	46.57%	24654	30.5	89643

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INFOSYS - THE RISE OF THE STOCK WAS INFLUENCED AS MUCH BY THE P/E RATIO AS BY ITS EARNINGS



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HDFC BANK:

Good businesses mainly from the small and mid cap arena having years of consistent and predictable growth ahead generally go through a sideways price consolidation instead of a deep price correction. Such companies do not necessarily see a price damage even if the P/E expands too rapidly for its current earnings as the stock price waits for, earnings to catch up. HDFC Bank's stock rose 8 times between 1996 and 2000 while its P/E expanded from 31 times in March 1996 to 44 times by March 2000. In the same period, the bank's valuation on a price to book basis exploded from 2.92 times to 8.33 times but as the market cap was small and future earnings predictable, the market did not push the stock down and HDFC Bank stayed in a price band of ₹40 to ₹50 between 2000 and 2003. During this period, the Bank also merged itself with the Bennett and Colman controlled Times Bank and a merger with a bank quoting at a lower valuation, both on the price to book and on a P/E basis also helped cool off HDFC Bank's valuation to a large extent.

By 2003, the stock price hovering in the same band looked less expensive than what it did in 2000. The increased earnings with no price movement had now put the price of HDFC Bank to 2.95 times its book value while its P/E ratio had dropped to 17 times its trailing earnings. The stock after a three year sideways movement jumped 61% over the next 12 months to ₹75.75 in 2004 from its March 2003 price of ₹46.91.

HDFC Bank holding onto its price in spite of a very high P/E is commendable in the backdrop of the severe bear onslaught that the Indian markets were witnessing between March 2000 and March 2003. The tech bubble had been pierced and investors had all the reason to sell a stock down on the pretext of high valuations but just because the earnings predictability was strong, the markets bore with the company's extended valuations till such time that the increased earnings made the valuation appear cheap again.

For an amateur investor who did not understand the market but just focused on a high quality stock, buying HDFC Bank at its peak valuation of over 40 times trailing earnings and 8 times price to book in March 2000 would have created tremendous heart burn for the next three years. However, if he held

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on for the next thirteen years till March, 2013 he would have still generated an annualised return of 21.22% (excluding dividends).

Now had he bought the stock in March 2003, after valuations had become reasonable then his CAGR for the next ten years excluding dividends would have been 29.62%.

HDFC bank never traded at a high dividend yield but to compute total returns one can add 1% which was the approximate yield of the stock, to the returns above.

QUALITY OF BUSINESS MATTERS IN CREATING LONG TERM WEALTH:

It makes a difference to buy a stock cheap, but the quality of the business matters more than the valuation at which the stock has been bought. *A good business is more important than a good valuation as inferior businesses can destroy good valuations whereas good businesses can mend bad ones but there*

HDFC BANK – THE P/E EXPANSION STAYED AND WAITED FOR EARNINGS TO CATCH UP

Year	Price (₹)	Net Revenue (₹ crores)	EPS Growth	RoE	P/E Ratio	Price to Book
March 31, 1996	6.48	57	-	9.63%	31.12	2.92
March 31, 1997	9.04	104	95%	17.42%	22.32	3.70
March 31, 1998	14.16	164	54%	23.87%	22.42	4.95
March 31, 1999	13.83	214	30%	26.41%	16.78	4.09
March 31, 2000	51.44	425	44%	29.00%	43.37	8.33
March 31, 2001	45.67	682	45%	24.59%	26.43	6.09
March 31, 2002	47.32	965	27%	18.3%	21.50	3.43
March 31, 2003	46.91	1287	25%	18.1%	17.06	2.95
March 31, 2004	75.75	1818	31%	20.14%	21.10	4.01
March 31, 2005	114.73	2429	28%	20.44%	25.03	3.93

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is however no substitute to buying a good business at a good valuation. Even after a large P/E expansion, investors in HDFC Bank still made money just because the market was betting on predictable earnings growth which the company finally delivered. Had the earnings been erratic, the market would have put the stock down and adjusted it for its overvalued P/E. Share prices of good companies continuing with the growth momentum tend to wait for earnings to catch up, a phenomenon that most market participants don't account for while evaluating stocks.

BHEL:

In the case of BHEL, the darling of the 2008 infrastructure, real estate and capital goods bull run, the stock price appreciated 25 times led by a near 4 time expansion in the P/E ratio. This increase in valuation was also influenced by the above normal growth as while revenues grew at 22% for the five year

BHEL - ITS THE P/E EXPANSION THAT DROVE THE STOCK PRICE.

Year	Price (₹)	Revenue (₹ crores)	EPS (₹)	P/E Ratio	RoE
Slow Phase:					
March 31, 2001	14.2	7643	1.28	11.09	8.7%
March 31, 2002	16.9	8057	1.91	8.85	11.1%
High growth Phase:					
March 31, 2003	22.34	8320	1.82	12.27	9.4%
March 31, 2004	60.45	9175	2.69	22.47	12.5%
March 31, 2005	76.74	10992	3.90	19.67	15.8%
March 31, 2006	224.70	15072	6.86	32.75	23.00%
March 31, 2007	226.08	19563	9.87	22.90	27.5%
March 31, 2008	574.77*	22486	11.68	49.20	26.5%

*Price as on November 14, 2007 which is also the peak price.

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period of 2003 to 2008 the net profit margin of the company aided by operating leverage, expanded from 6.1% to 13.8% indicating that a super normal growth in revenue isn't always necessary for a stock to be a multibagger. In this case, the stock went up 25 times backed by an increase in net margin and revenues. The P/E ratio expanded by 4.01 times to 49.20 in November 2007 from 12.27 in March 2003 and remained the main driver in setting the stock up for a near 25 times move.

After the 2008 growth slowdown, the stock price of BHEL started to decline even as earnings kept on increasing and by 2013 the stock was down 80% on a P/E which had collapsed to under 5 times. Interestingly, the profits had more than doubled in this period even as the stock continued to fall. The market had reached a point where it was not willing to believe in the BHEL story anymore.

Novice investors would have bought the stock on rising earnings not realising that earnings of capital goods companies react to economic slowdown with a lag because the company kept reporting increased earnings as its past order book got executed over a period of time even as new order flows slowed down. The key thing to watch out for BHEL would have been the growth in its order book and not the increase in the current earnings which came from the execution of the orders, received in the past.

TTK PRESTIGE:

Consumer stocks are leading a rally in the Indian markets from 2009 where several such companies have risen manifold thus rewarding their shareholders quite handsomely. One of the prominent gainers in this list is TTK Prestige which is up 35.54 times between March 2009 and March 2013. During this period the company saw its EPS move up by just 5.83 times whereas the major increase in price was supported by a super normal increase in P/E from 4.6 times trailing in 2009 to 28 times in FY13. The net profit margin also increased from 5.55% in 2009 to 9.76% in 2013. In all these stocks it is normal to see the net profit margin expand due to the operating leverage that accrues from an enhanced sales growth.

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P/E EXPANSION OF TTK PRESTIGE				
Year	**Price (₹)**	**Revenue (₹ crores)**	**EPS (₹)**	**Trailing P/E**
Slow growth Phase:				
March 31, 2007	122	281	10.37	11.76
March 31, 2008	116	326	18.21	6.37
High growth Phase:				
March 31, 2009	91	402	19.72	4.61
March 31, 2010	609	509	46.32	13.13
March 31, 2011	2243	764	73.98	30.31
March 31, 2012	2945	1104	100.13	29.41
March 31, 2013	3243	1359	117.35	27.63

SETTING EXACT LEVELS OF THE P/E IS FUTILE:

Overall, setting exact levels of P/E expansion is futile. If an investor thought that Infosys was expensive at 49 times in 1998, its P/E expanded to 72 in 1999 and then to 322 by March 2000. If an investor debated that Infosys should have been sold at a P/E of 322, Wipro went to a P/E of 500 as it was more illiquid because of a lower float. In the 2008 infrastructure boom, the P/E ratios of BHEL, L&T and Unitech expanded multifold from a single digit to around 50 times which brings us to the argument of holding the stock for the entire length of the bull run and then selling out even after the stock falls on the first signs of a breakdown. The idea is to sell on confirmation of a break in the trend rather than on an apprehension of the reversal because the last leg up is the most vicious of the entire move. Alternatively, an investor who does not sell on the culmination of a trend stands to lose a lot as the fall in price of a stock that adjusts to a slower growth is rapid and severe where several years of price advancement are neutralised in the first few months of the downmove.

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“In markets, prices move first reasons follow later. However, in research reports prices move first, targets change later to adjust to new prices”

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Chapter 27

SHOULD A SMALL INVESTOR ALWAYS STICK TO SMALL CAP STOCKS?

Without market cap classification, a simple and immensely profitable strategy is to only own stocks that are more than 100 times their face value. A portfolio thus formed would include only bluechip stocks such as Nestle, Tata Motors, TCS, HDFC twins, Asian Paints, ITC, Page Industries, L&T etc!

The market capitalisation of a company is a function of the current and future earnings potential of the business and refers to the amount of money that would be needed to buy all the outstanding shares of the company at the prevailing market rate. Most young fast growing businesses start as small market cap companies and slowly graduate into mid and then larger capitalised companies. Other things remaining same, an investor can tell a great deal about a company and the scope for further growth by looking at the absolute market cap only.

MARKET CAP CLASSIFICATION:

Though there are no rules in this game the definition of a small cap varies depending on the overall level of market capitalisation. While the Americans might consider a $500 million company as a small cap the same company might be considered a mid cap in the Indian context. This is because the U.S and Indian markets are differentiated by an overall variance in market caps both at the market as well as the specific company level. With a market cap of $14 trillion, the U.S is almost twelve times ahead of the $1.2 trillion market capitalisation of the Indian stock market. Hence, from an Indian context we can make the following market cap classification:

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TYPE	MARKET CAPITALISATION
Micro Cap	Up to ₹250 crores
Small Cap	More than ₹250 crores and up to ₹1,500 crores
Mid Caps	More than ₹1,500 crores and up to ₹6,000 crores
Large Caps	More than ₹6,000 crores

Small and micro cap companies are startup type businesses which have the potential to provide significantly outsized returns to their early investors. Most of the large caps of today were the small caps of yesteryears and on an overall basis small caps generally outperform the bigger companies till they become large caps after which they start generating normal returns only. *Smaller sized companies carry higher risks and are bought for larger gains whereas larger sized companies carry lower risk and are therefore bought for smaller but relatively surer gains.* The difference between the two is that gains from smaller sized companies is uncertain and in most cases unknown. Compared to this large cap blue chips deliver strong, consistent and predictable returns. The higher rewards of these small caps compensates the investor for the unpredictable and volatile nature of their stock price movement.

ABSOLUTE PRICE MEANS NOTHING:

As the market capitalisation of a company is computed by multiplying the market price of a stock with the number of outstanding shares, a company with too few shares and a higher price could be at a lower market cap than another, that trades at a lower price with a significantly larger number of shares.

The absolute market price therefore means nothing in evaluating whether a stock will move up in the future or not. In this era of dematerialisation, a person can buy a few shares of a high priced stock or a lot many of a low priced one and none of these options will make a difference whether such

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an investment will be profitable, as the primary drivers of making profitable investments are earnings and valuations rather than the absolute price at which each portion of the business is transacted at.

For instance, Hawkins Cooker which trades at a market price of ₹2,175 and has a market capitalisation of ₹1,149 crores is still a small cap company whereas Steel Authority of India Ltd which trades at a price of ₹ 66.45 for a market capitalisation of ₹27,447 crores is a large cap enterprise whereas the absolute prices of these companies do not quite express the difference in market cap at all.

SMALL CAP INVESTING:

Most small cap companies suffer from inferior management bandwidth as they remain engaged in a business that is yet to be tested on a larger scale either due to lack of execution capabilities or non-availability of business opportunities. Most of these companies appear and remain cheap for long periods of time as they operate in a highly competitive environment with a busines model which is vulnerable to external environment changes. Small cap companies without entry barriers are unsuitable for long term investing and represent the most prominent segment of business failure as on an average only one out of a few dozen of such small cap companies possess the capability to become really large sized corporations.

Recommending small cap stocks is a top selling point for most investment advisors, brokerages and research houses. An investor who buys small caps is perceived to possess a sophisticated investment strategy, superior to someone who just buys large cap blue chip stocks. Similarly, a person who talks mostly about the smaller capitalised companies will be in demand and is more likely to draw a crowd around him at marriage parties and investment seminars than someone who is recommending just large cap stocks. *While small companies outperform the large cap names over a very long period of time the returns tend to swing wildly and contrary to popular belief there is no guarantee that a small cap stock picker will always outperform an investor who focuses purely on large caps.* This is because small cap stocks suffer from a large variance in returns so an average investor who focuses exclusively on

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small caps should spread himself thin and wide within the small cap universe as one stock may deliver a 100% return while another may fall by 70% to show an average return of 15%. While averages don't lie they don't tell the truth either, just like the story of a man who got drowned trying to cross a river that was on an average only four feet deep. Generally, small caps tend to perform well in a raging bull market but in case of a severe bear grip these small caps tend to fall harder and are susceptible to falling 30% to 40% without much support. On the other hand, these small caps also double up with effortless ease on the first signs of recovery.

LOOK OUT FOR ENTERPRISE VALUE:

The small cap argument is meaningless for a company with huge amounts of debt on its balance sheet. Some companies that appear to be small caps in the absolute definition of the market cap theory are in fact not so small when considered in light with the enterprise value (market cap + debt). Arshiya International was one logistics service provider whose stock price slipped from a high of ₹362 in October 2010, to ₹15 by 2013 pulling down its market cap from a peak level of ₹2,220 crores to around ₹96 crores. So Arshiya with its huge assets would have appeared cheap on a market cap of ₹96 crores but the debt of around ₹2,000 crores deterred any buyer from making a meaningful bid for the company because the market cap got dwarfed under the larger enterprise value.

Gitanjali Gems is another stock whose consolidated revenue at over ₹16,000 crores looks very high for its market cap of ₹450 crores but the overall level of consolidated debt at over ₹5,000 crores makes up for an enterprise value of ₹5,450 crores indicating that the stock isn't as much of a bargain as it appears if one were to just look at the market cap. A company headed for bankruptcy would have a very small market cap but the enterprise value would be several times the market cap. This is so because the market would have already knocked the stock price down fearing a financial catastrophe which would have resulted in an abysmally low market cap when compared to its enterprise value.

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THE MINIMUM REVENUE THRESHOLD TEST:

Most investors are attracted to the notion of investing in small and micro caps for making quick returns from the stock market as the potential to generate a multibagger is highest amongst the small and micro cap list. One test to follow in this endeavour is not to invest in a company which has a revenue of less than ₹100 crores as setting a minimum level of revenue qualifies the company for a test of its business model. Another test for small cap investing is to check whether the company has a niche or a moat for its product which would help it survive the overall market competition. If the product has strong entry barriers with market leadership potential then the ₹100 crore revenue threshold criteria can be ignored but those instances should be rare and uncommon. It is better to bet hard on an expensive stock which has been tested for its business model rather than to look for a business that is yet to prove its business plan on a commercial scale even though the degree of gain could be more in the latter than in the former.

SURVIVORSHIP BIAS:

If buying small and micro caps is the way to riches it is also the path to bankruptcy. More than 90% of the 7000 stocks listed on BSE are small and micro cap companies out of which only a handful will graduate to become the large cap blue chips of the coming years. The odds of chasing small and micro cap companies to make outsized investment gains aren't as high as it seems at first. The data of small caps graduating to become the large caps of tomorrow is filled with survivorship bias. *For every Infosys and Wipro that made it to the big league there are a list of companies that failed to deliver and thereby fell by the wayside.* The challenge to wade through the clutter and pick out the winner is both a mix of skill and randomness - at least to the initial individual investor who isn't as diligent as he ought to be.

ILLIQUIDITY AND CONSTRAINTS IN FUND RAISING:

Another issue with smaller capitalised companies is the abysmally low volumes they trade for, making it difficult for an investor to buy any meaningful quantity without disturbing the price. It's ironic that while small cap focused

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mutual funds justify their investment strategy and fund raising program on the basis of past price data of these small cap stocks in actual life these mutual funds cannot buy these very stocks that provided a major chunk of the returns because of lack of trading liquidity. As small caps don't have too much of institutional following because of market cap constraints and lack of trading liquidity their capacity to raise funds through placements to institutional investors through QIP is severely restricted. While larger sized companies can raise funds by quickly placing shares to institutions and mutual funds the smaller sized businesses suffer from the lack of that advantage. *Not raising funds at an opportune time is also a reason for the high mortality of smaller capitalised companies because many times a listed company survives a bankruptcy scare just because it is able to raise equity from the markets.* Unitech's early 2009 placement not only brought life into the company but also signalled the end of the bear market as the market saw it as a sign of the investor's willingness to put money into companies that had seemed headed straight into bankruptcy. Many times large block deals and subscription of QIPs of companies in a distressed sector signal an end to a bear market which is exactly what happened in March 2009, when Unitech made a private placement just before the Sensex made a 'U' turn towards 21,000 from 8,500!

WHEN TO LOOK FOR SMALL CAPS?

In spite of these drawbacks, a carefully chosen strategy for small cap investing has the potential to generate astronomical returns, change lifestyle and take an investor towards the path of financial freedom. The imperative point of observation is that small cap investing should not be a compulsive feature of an investment strategy which means that an investor should not always force himself to buy small caps. *The process of identifying a promising stock idea should be based on the investment potential of the underlying company and should not be exclusively focused on the market cap of the same.* There will be times in the market when the relative opportunity of a mid cap or a large cap blue chip will exceed that of a small cap and there will be times when a small cap would appear to be a no brainer. An astute investor should wait for these market signals before jumping in to buy.

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MID CAPS:

Mid caps are relatively larger companies whose business model has been tested to some extent. Unlike the small caps, the liquidity in mid caps will be relatively higher making it possible to attract larger institutional interest. While the maximum money is made in small caps an individual investor would sometimes be better off investing when a company reaches a certain degree of scale and size. This would indicate that the company's product or service along with the management's ability to scale up and execute would have been tested on a commercial scale.

Most mid caps shut down because of excessive debt and an inefficient management than due to a failed business plan. However, in the case of a small cap the shutdown rate is higher mostly for businesses whose economic character is faulty and unfit for being scaled up.

While management integrity remains an issue with mid caps, the probability of getting a rogue management reduces as the company increases in scale and size. This does not mean that the chances of encountering an unscrupulous management is zero for larger capitalised companies but just that the odds are better as we move towards larger sized businesses. The argument is that a dishonest management would not have waited for the company to become big before starting to cheat and if they were cheating it would not have been easy for them to expand their business unless there was a bull market waiting to take the stocks up. But like all investing arguments there is always an exception everywhere and there have been instances of large corporations both in India and abroad who have been proved for fraud. Two names that come to mind on this are Enron and Satyam Computers.

Some institutions have a threshold criteria which does not allow them to invest in companies with a market cap of less than $250 million. These restrictions make it extremely difficult for smaller capitalised companies to have institutional interest unless they become larger companies with a minimum threshold limit. Instead of employing market cap filters as most mutual funds and institutions do, an investor would do well if he employed filters of scale and size of revenue as indicated above, as in a fierce bull market

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many untested and unknown small caps are manipulated into becoming large caps which when the market turns, revert back to become small caps again.

LIMITATIONS OF NOT HAVING SCALE:

The limited scale of business activity in these small and mid cap stocks makes it difficult for them to spend significant amounts of money in research & development, advertising and innovation through new product launches. The lack of scale also restricts the ability of these smaller sized companies to pay market related compensation packages in hiring a high quality managerial team or to create operating leverage by spreading the fixed costs over a larger number of units. No wonder then that most small and mid caps that become large caps have smart and passionate promoter who work more for their passion rather than for the upfront cash compensation.

LARGE CAP BLUE CHIPS:

Large cap blue chips are the strong and established companies that have moved up the fast growth curve and are now growing at a relatively slower clip than what they were growing at earlier. *Contrary to popular opinion, most of the time large cap stocks offer a better risk reward payoff to the normal investor because these businesses suffer from a very low business mortality. The gains in a non cyclical large cap stocks are surer and come with a reasonable degree of predictability making them excellent long term compounding machines.*

As a general rule, *the growth of a company is inversely related to its market cap* and hence large caps are not the areas to look for multibaggers. Though Bharti moved up more than 40 times after it became a $1 billion market cap company such examples are neither normal nor common because most large caps can at best be decent compounders as the scope for P/E expansion remains limited after a stock reaches a higher market capitalisation level.

The returns from investing in these large cap stocks are lesser than what one could make buying a small or a mid cap company. But for an individual investor having little expertise in picking stocks, large cap names provide a very good avenue for accumulating wealth. The strike rate of success in

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these large caps is generally higher when compared to small cap companies even though the potential for absolute gains remain loaded in favour of small cap stocks.

NO SINGLE STYLE:

However, most investors ignore this group of 18% to 20% large cap blue chips and move into the small and mid cap space to look for that winning stock bet as *most investors prefer an uncertain 30% over a certain 20%; whereas a few astute ones think the reverse.* Without a P/E expansion a small cap company will find it very difficult to outperform the large cap names. On the other hand, there is a general sense of achievement in identifying a profitable investment opportunity from the smaller sized companies even though the rewards of research don't compensate for the risks of trade all the time. Individual investors should therefore not be biased on a particular investing style all the time. *Depending on opportunities and market conditions his ability to make returns will be accentuated by his willingness to remain flexible and swing between stocks of all classifications rather than be guided by the market cap syndrome of a particular type.*

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“Brokers and advisors don't realize that their ‘Buy Now Sell Tomorrow’ (BNST) calls have finally killed the hen that used to lay the golden egg for them”

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MULTIBAGGERS FROM SMALL AND MID CAP STOCKS

The number of times a stock can go up in future is dependent on its earnings growth and not on the number of times it has moved up in the past.

Small and mid cap investing is risky but that is where most of the multibaggers come from. A small cap stock with a pragmatic management and a business model that is both scalable and profitable has the potential to move up several times. But as small caps suffer from a high risk of failure an investor should have a strong screening process before betting on these smaller sized companies. The screening process applicable to most companies and specifically to smaller sized businesses range from scalability in the business model, secular growth, high RoE, sector leadership, management focus, cash flow generation, earnings predictability, reasonable debt and a stated dividend payout policy with growing yield.

Many points covered in this chapter will overlap with those from the note on 'How to identify a new trend?' This is because most of the new trends start from small caps and hence the overlap in the write up but overlapping can be identified elsewhere in the book also as things that are relevant for the respective chapters are being repeated to retain the message rather than be omitted to avoid the duplicity.

Unlike the business channels, where an investor gets to see a multibagger recommendation every few hours finding a multibagger is not a weekly event. Stocks which make their investors rich by ten, twenty and fifty times generally emerge after a steep market decline and before the next immediate upmove as it happened in April 2003 and also in March 2009. *There has to be*

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an overall catastrophe because the basic ingredient of a multibagger is the multifold expansion of a low and suppressed P/E ratio which can happen only when markets are at the bottom and ready to move up rather than when they are already a couple of years into a bull run.

Most of the potential multibaggers will attract attention at first sight only and need no special effort for being uncovered. The trigger will mostly be the growth and scalability of the underlying business rather than the absolute valuation at which the stock trades at. If the research to get a great idea is getting hard then it isn't worth the effort because it indicates an error in the original thesis. In other words, an investor should be able to call a stock as a buy or a sell without taking help from his excel sheet because the potential of the stock should actually stare at the face and not whisper from a distance.

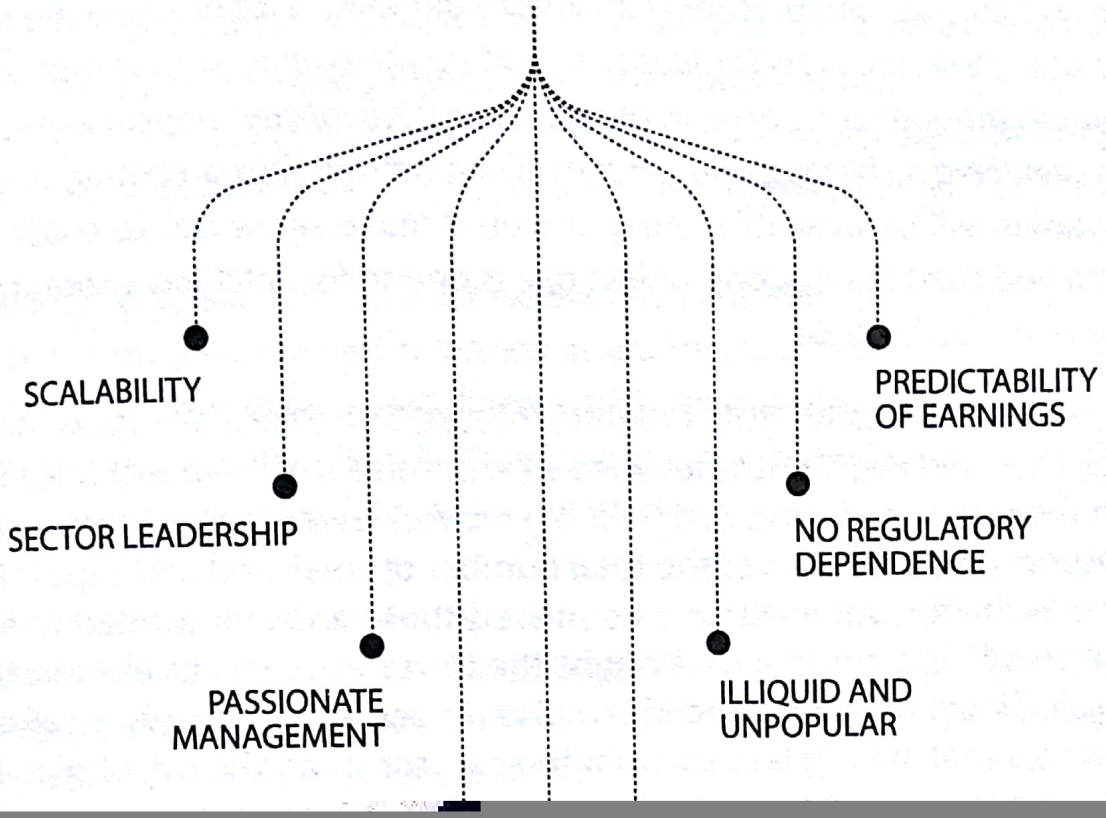
SCALABILITY:

Most mid and smaller sized companies find it difficult to scale up and execute their business plans even though any company that expects to return super normal profits to its shareholders should be engaged in a business which is scalable. Scalability refers to the external scale of opportunity and businesses that do well for their shareholders over longer periods of time are generally involved in an activity where the scope for growing revenues year on year is humongous, when compared to the current revenue of the company. A business is assumed to be scalable when it has the potential to generate volume growth by getting new customers for its products. The scalability of a business is generally correlated to the growth of the overall market in which the company operates. A company will generally find it easier to grow at 25% if the underlying market is growing at 20% however, if the market itself expands at 10% then a company will find it hard to report even a 20% rate of growth unless a major chunk of the market consists of the unorganised sector in which case the companies in the organised space can keep growing by taking away market share from the unorganised sector.

Software, infrastructure, real estate, retailing, mobile telephony, consumption, financial services, pharmaceuticals are all businesses that provided a huge scope for business expansion for the early entrants. Some of these businesses like low ticket rural and semi urban mortgages can safely be assumed to have at least 20 years of uninterrupted growth ahead of them.

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MULTIBAGGERS FROM SMALL AND MID CAP STOCKS



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SECTOR LEADERSHIP:

Small and mid cap sector leaders invariably generate a lot of wealth for their early shareholders. *A sector leader would be the company that makes the maximum amount of revenue in the sector and will always appear expensive when evaluated on historical parameters.* Even though the competing smaller companies will be available cheap it would make sense not to chase the second and third tier options, unless one is opting for catching a short term undervaluation bounce.

Companies like Nestlé, HUL, Colgate, Infosys, Sun Pharmaceutical, Asian Paints, Titan and Page Industries were all expensive small cap sector leaders when they started making their first big move. However, these companies represents only a fraction of the total number of small and mid caps listed on the exchange. An investor who missed these and still wanted to buy cheap small caps could have bought the lower rung stocks like Mastek, Gitanjali, Global Trust Bank and Maxwell in the respective sectors. Small cap companies that are not leaders from their sector stand the risk of slipping down on delivery and execution both from the earnings and subsequently from the survival point of view.

LEADERS SET THE PRICE:

Sector leaders are also the price setters of the industry. So an Asian Paints will always be the first to raise prices which will be followed by all the other companies in the sector. Similarly, Havells will be the first to raise prices and not V-Guard, while a price rise at Hindustan Unilever Ltd will come first when compared to a Jyoti Laboratories. In the cement space, ACC will raise prices first rather than a Heidelberg Cement whereas a Tata Steel's decision to increase prices will always come ahead of the smaller players.

WHEN IS IT NOT NECESSARY TO BE A SECTOR LEADER?

There are some sectors where it isn't essential to be the leader because the sectors are themselves huge in size. In such cases, the market remains uninfluenced by a single player as is the case of companies engaged in the business of financial services. Another sector where it isn't necessary to look for a leader is a business whose product is high in volume and low in value. These businesses are separated by geographical compartmentalisation due

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to the costs of moving goods from one part of the country to another, which helps in creating local industry leaders. In some cases, a niche product like a regional newspaper or a television channel captures a certain area due to high customer recall and protects itself from new entrants in spite of being a smaller player. A classic example here is a Sun TV which has maintained its niche and profitability when compared to the relatively larger Zee Network.

The lending business is a sector where each company is just an aggregate of all its branches with each branch operating as a separate business unit. Small banks like Karur Vysya Bank which from a single digit market cap company in the early 1990's is up several hundred times thus outperforming their larger sized cousins by a huge margin.

Cement is a sector where transport costs prohibit the movement of cement from one part of the country to another. So even while ACC and Ambuja Cement were market leaders Shree Cement a relatively smaller company in the 1990's, efficiently managed resources to increase its capacity and dominate the local area of operation. A high capacity utilisation rate coupled with captive power production helped Shree Cement keep its costs in check. Over the past two decades, the company has increased its capacity more than fifteen times to around 15 million tons per annum and the market has responded by pushing the stock up more than 100 times from ₹46 in 2003 to ₹4,600 by 2013. This stupendous 58% CAGR in price was achieved by a 28% CAGR in revenues and a 65% CAGR in net profit. Increasing revenues provided the much needed operating leverage as the company grew without diluting equity or by taking too much debt. The 11% annualised growth in debt was significantly less than the growth in revenues, indicating a healthy financial set up.

Sometimes the second and third liner stocks may make sense for buying as their depressed valuation might make them attractive for a rally to the extent of narrowing down the valuation gap between the second liner and the sector leader. However, to safeguard himself from the possibility of getting trapped in these smaller stocks *an investor should check whether the second or third liner stock in a sector is a) paying full taxes or b) distributing dividends because these two outflows are the real proof of whether the financial numbers are for real or not.*

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A few more sectors where shareholders need not look at sector leaders while betting on a stock are hotels, hospitals, speciality retail chains or any other business that operates as a separate unit for each of their branches.

PASSIONATE MANAGEMENT:

In the initial days of growth, a small sized company suffers from lack of adequate resources to hire the right type of managerial talent. Due to its small size it finds it hard to pay top dollar to hire the best managers and as the company can't pay top dollar to recruit the best talent, its size can't be increased beyond a point making it like a chicken and the egg game. This makes it imperative for an investor focused on small cap investing to look for a company with a passionate promoter whose incentive to work isn't designed by cash compensation only. *Managements who are technocrats and specialists in their own field are more suited to taking a small cap company up the growth path. In addition to having the skills of the game these people would also be great problem solvers and also excel in delegating the work because a company that is a one man show cannot increase too much in size.* N.R. Narayana Murthy of Infosys, Azim Premji of Wipro, Dilip Sanghvi of Sun Pharmaceutical, Brij Mohan Munjal at Hero Honda were all unknown names when they started their businesses. The management competence and integrity should be of paramount focus while dealing with relatively small and unknown companies. Conversely, United Spirits and Raymonds are two such companies that would have done better had their managers been as passionate about their business as they were about other things.

NO NEED TO FOCUS ON CHEAP VALUATIONS:

No less money has been lost by buying cheap stocks that failed to become expensive than by buying stocks that were expensive to start with. While buying smaller sized companies an investor should not spend too much time haggling about the price. A prospective multibagger should start from a reasonable P/E ratio. The P/E need not be very cheap but should not be too expensive either because if it is too expensive then it would price in years of gain ahead and the stock would become just a compounding machine mirroring the earnings growth only but if the earnings growth is very strong then paying a slightly higher P/E to buying a smaller position can also be contemplated.

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As these companies operate from a low base the potential to show big earnings growth is sometimes ignored by investors in their endeavour to compute the right price for the stock. *A small cap making rapid earnings advances could could become cheap in a matter of a few quarters and hence holding back a purchase just because the stock appears to be 10% or 20% higher to an assumption based fair value could be detrimental to picking up a winning stock. The pain of seeing temporary losses on shares that have an excellent future is less than the trauma of not buying those stocks when they start to move up significantly.*

Small cap ideas with potential to create that retirement fund don't come too often and even if they do there is no guarantee that an investor would notice and pick it up. So these ideas need more of business and management analysis rather than a debate on the right price to buy such a stock. *If all multibaggers started as small caps then all sector leaders that fell 90% were large caps so the fear of loss from a small cap sector leader isn't as much unless it becomes a large cap.* If a small and mid cap stock has the potential to move several times ahead it would generally not be available at an excel sheet determined 'fair value'. *An investor should therefore buy a small quantity and add more to a promising idea if the price moves downward without any change in fundamentals or the earnings go up without any change in price instead of waiting for prices to fall down in absolute terms.*

If an investor likes an idea but wants to buy it 20% lower to the current market price then one strategy is to take a 2% exposure instead of allocating 5% to



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CONSISTENT REVENUE AND EPS GROWTH:

A potential multibagger should be generating consistent year on year revenue and EPS growth. While looking for revenue growth, an investor should not focus on one or two years of growth unless the external environment in which the business operates has undergone a change in this time period. What matters is a sustained and consistent annual growth rate of at least three to four years. Linearity in growth matters more than the absolute level of growth because a stock that grows at 50% in one year and 10% in another isn't as good as one which grows at 25% for each of the two years. Achieving an above average revenue growth is an indication that the company is achieving scale and if a smaller sized business can achieve scale, profitability will follow. Here growth in profitability refers to EPS growth rather than the growth in absolute profits as such.

SUN PHARMACEUTICAL - IT WAS NEVER TOO LATE TO BUY THIS GROWTH MACHINE

	18 year CAGR	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003*
Revenues	30.74%	11689	8491	6083	4213	4481	3501	2374	1805	1230	999	733
Net Price	31.56%	2983	2657	1816	1347	1878	1551	840	573	400	345	231
Price (₹)	34.58%	409	285	221	179	111	123	105	87	47	32	14

	2002*	2001*	2000*	1999*	1998*	1997*	1996*	1995*
Revenues	759	621	481	359	282	191	131	94
Net Profit	169	135	91	59	56	49	37	21
Price (₹)	17	14	16	4	2	2	2	1.95

* Standalone results
All figures are for 31st March of the respective years
Revenues and Net Profits are in ₹ crores

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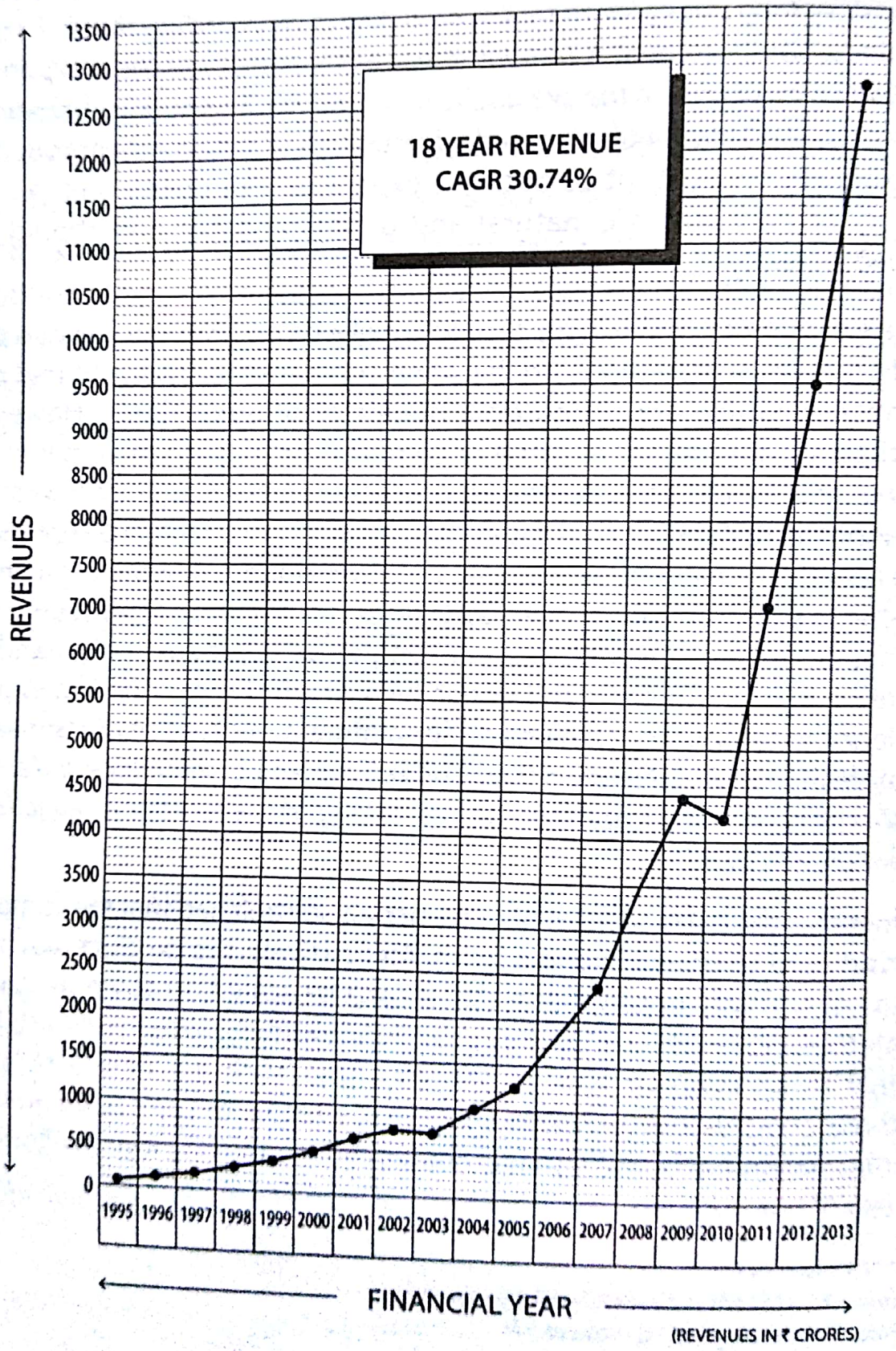
Quarterly aberrations in profitability is not as much of a concern for a long term investor as it is made out to be by the analyst community. Companies with years of growth ahead of them will in all likelihood go through temporary aberrations of subdued sales and profitability which is normal as all companies pass through the normal ups and downs of business cycles. *While a temporary period of slowing sales growth should be looked at very carefully the chances of the aberration becoming a trend is lower when the size of the company is small when compared to the overall size of the market.* Temporary aberrations in profitability because of increased advertising and selling expenses or due to expenses on account of business expansion like opening up a new factory or new stores is natural and understandable and should be viewed leniently.

In case of large caps, the focus should equally be on both the revenue and profit growth, a little more strictly when compared to small and mid cap companies which are sitting on a huge size of opportunity. However, profitability aberrations because of compression in gross margin is more serious and should be evaluated as to whether such a margin compression is temporary or permanent in nature. A permanent gross margin compression as a result of increasing raw material costs will indicate that the company is unable to pass through its input costs to its customers. Sometimes there is a time lag between a company initiating a rise in product prices and an increase in its input costs and under such circumstances one can extend leniency to temporary earnings disappointment because of gross margin compression as well. *Investors should absorb the temporarily lumpy and erratic profitability of smaller sized companies as long as the revenue is reflecting a linear growth trend.*

Sometimes the balance sheet of a company is so stretched that the company finds it hard to grow beyond a point. Alternatively, the product reaches a stage of maturity or saturation that it can't be scaled up anymore. Under both these cases the lacklustre growth in revenues will provide the best signal to an investor and he should under such a scenario think of reconsidering his investment irrespective of whether the profits are growing or not. Revenue and profit growth should thus be moving together and not in lieu of one another.

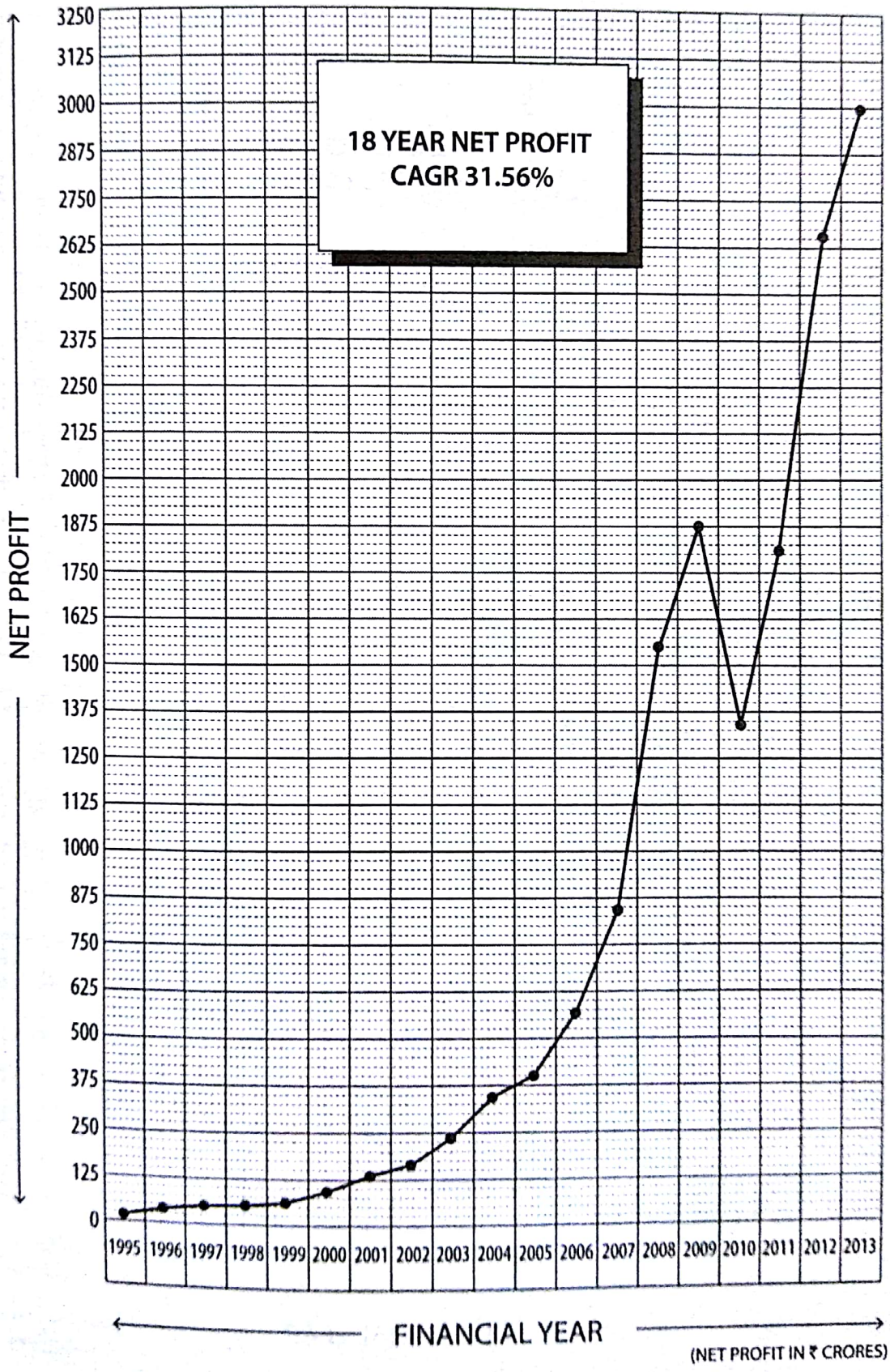
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SUN PHARMACEUTICAL - IT WAS NEVER TOO LATE TO BUY THIS GROWTH MACHINE BUT INVESTORS KEPT FOCUSING ON HOW MUCH IT HAS MOVED IN THE PAST RATHER THAN HOW MUCH IT COULD MOVE IN THE FUTURE



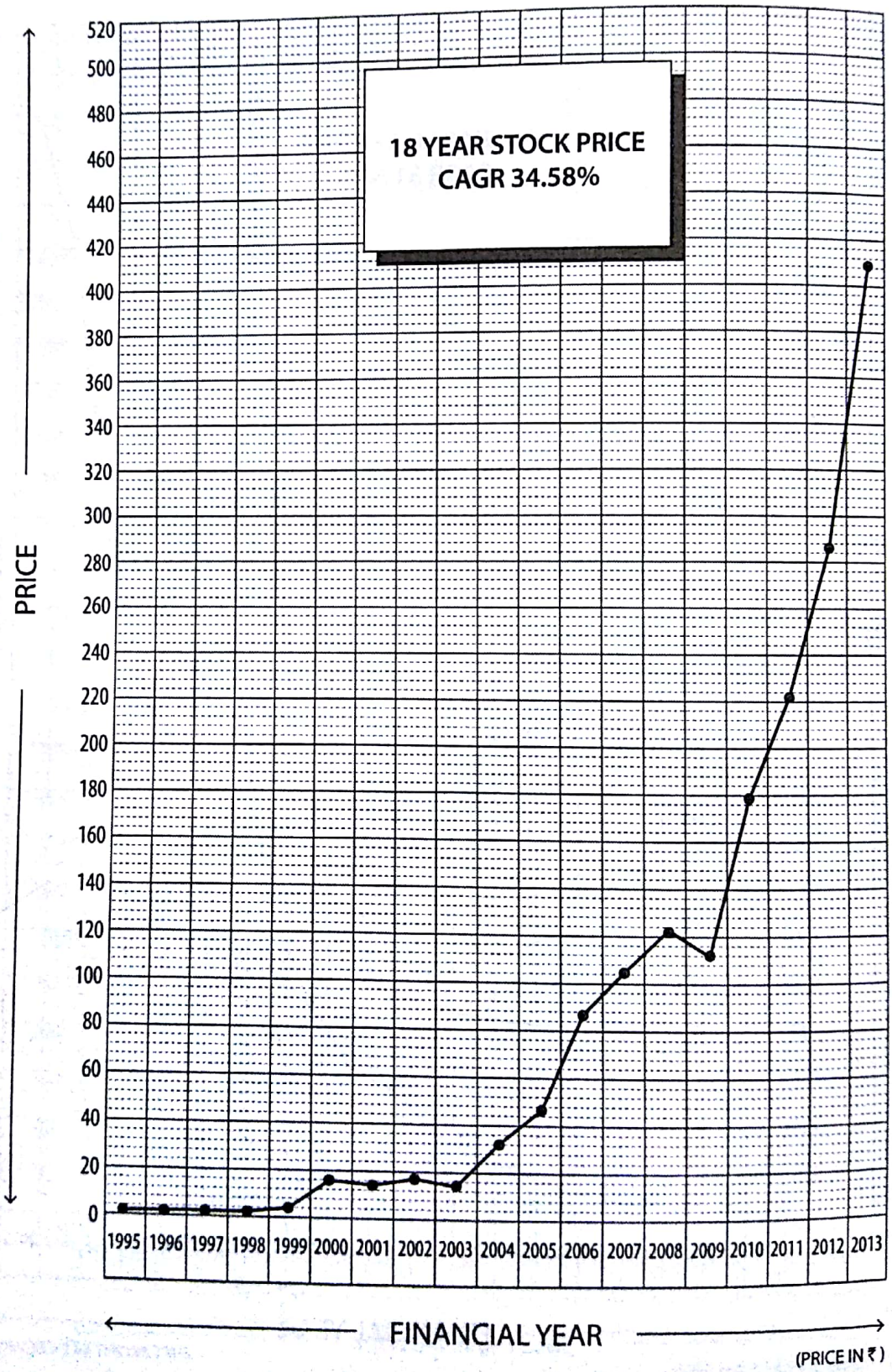
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PREDICTABILITY OF EARNINGS:

While buying small and mid sized companies an investor should also focus on businesses which are predictable for their earnings visibility. *Looking for predictability of earnings automatically eliminates the cyclical and commodity plays from the list. It is advisable to ignore the small cap cyclicals and instead focus on the large companies when it comes to betting on cyclical plays.* A small cap cyclical faces business risks because of competitive challenges from its large cap peers. People who bought ACC in the early 1990's still have something to show for their effort but Kakatiya and Kalyanpur Cement have been long term destroyers of wealth. Similarly, shareholders of a large cap blue chip like Tata Steel can still get their initial capital with a nominal rate of return but buying small and mid caps like Lloyd Steel and Sunflag Iron have resulted in almost a complete loss of initial capital.

Ideally small and mid caps should be picked up either for niche businesses or for a new and emerging high growth sector. As a general thought, most investors look to compulsively invest in small caps instead of focusing primarily on the fundamentals of the company. *Most examples and data of small cap investing is loaded with survivorship bias where an investor forgets the losers and remains focused on the winners which underestimates the risks while overestimating the rewards.*

NO REGULATORY DEPENDENCE:

Some companies depend on government support like subsidies and tax breaks for their profitability. Investors would do well to avoid a business whose returns are influenced by government policy because such policies are dependent on abrupt changes based on populism and public welfare. Due to their limited lobbying power, small caps suffer from enhanced regulatory risk when compared to larger sized corporations. Suzlon is one example where the business faced severe headwinds once the government withdrew concessions of accelerated depreciation for windmill plants. In some cases, government regulations affect the scalability of an industry like the repeated RBI diktats on gold lending have affected the expansion plans of Muthoot and Manappuram Finance and regulations on micro finance lending in Andhra Pradesh put a brake on the expansion plans of SKS Micro.

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ILLIQUID AND UNPOPULAR:

Most small and mid caps are unpopular and suffer from the liquidity risks. The abysmally low trading volumes make it difficult for an investor to buy meaningful quantities of the stock and also sell it back at the time of his choosing. Optically, low liquidity is one of the biggest risks of investing as an investor might get blocked out from exiting the stock on the first signs of trouble. However, in case of trouble an investor gets blocked out from selling, irrespective of how liquid the stock is. Satyam Computers used to trade millions of shares a day and as soon as the negative news reached the market the stock slipped from ₹175 to ₹65 in minutes and by the morning of next day had dropped down to ₹10.

Arshiya International, another liquid name fell to ₹35 from ₹120 in a straight line on lower circuits before crumbling to ₹15. An investor can therefore get caught for lack of an exit option even with very liquid names. *Liquidity is not just about how many shares a stock trades today but is more of a function of how many buyers will emerge for a stock on the first sign of trouble and hence a totally liquid name may become thoroughly illiquid depending on the quantum of the problem.* Instead of looking for number of shares traded a completely risk averse investor should look out for debt free companies with a growing dividend yield.

An investor who intends to put in some part of his portfolio in small companies will have to go with the liquidity risk. He cannot expect a stock to be both liquid and unpopular at the same time. Being unpopular is one of the biggest traits of potential multibaggers so instead of ignoring small companies because of perceived liquidity risks an investor should look at mitigating the risks of business failure by employing a broad screening of the financials.

FINANCIAL ANALYSIS:

A company growing revenues and profits through frequent debt and equity dilutions; having a RoE less than the desired rate of growth and generating negative operating cash flows with a low payout ratio is a potential case for business failure. However, if the sector is in demand and the company growing at a fast rate then the financials don't matter till such time that the bull market

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subsides. Under general market conditions an investor in a smaller sized company should ensure that:

a) The RoE of the company is above 30%, here the net margin should not be looked at in isolation as they are only one part of the RoE computation. While computing the RoE one has to understand that a RoE amplified by debt isn't as good as a company which generates a RoE without employing too much debt. In other words, one should look for a robust RoCE as well. The attempt should be to try and identify that company whose RoCE is set to improve from lower levels. Aban Offshore earlier known as Aban Lloyd was one company that went up more than 500 times between 2002 and 2008, having a high RoE with excessively high debt. The stupendous rise in stock price of Aban Offshore was a result of a big bull market in crude oil which suggests that in case of a bull market in the underlying sector or commodity, other things do not matter too much.

b) A company that grows at more than its RoE faces growth challenges and gets over this issue by repeated equity and debt offerings both of which are easier to do in a bull market. *However, a company growing on repeated debt and equity offerings is like a patient on a ventilator who collapses as soon as the oxygen mask is removed from his face.*

c) The debt on balance sheet should be less than 50% of the net worth while in extreme cases this debt can go higher depending on the prospects of the business and other associated factors. Investors should ensure that the growth in debt is less than the growth in revenues and the debt equity ratio displays a stable to declining trend.

d) The company generates a positive operating cash flow; however companies that have a negative operating cash flow also do well in a fierce bull market.

e) The dividend yield is 1.5% to 2% of the current price while an illiquid stock without yield is a potential case for catastrophe. For liquid companies growing at reasonable rates and holding dominant sector positions, an investor can ignore the yield factor but having a reasonable yield is a necessary shield against illiquidity.

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There is an illiquid small cap stock called Cravatax which sells the 'Fila' brand of sports and leisure wear products in India. Many investors had bet on this when the stock moved up to ₹600 and then a couple of bad results was all that it took for the stock to lose 60% of its market cap as the stock did not have any yield protection.

SOMETIMES THE STOCK PERFORMS FOR AN ENTIRELY DIFFERENT LOGIC THAN WHAT IT WAS BOUGHT FOR:

Sometimes the original thesis in which a stock is bought has very little bearing on the reasons that cause the actual movement in the stock price. A similar thing happened to me post my purchase of Hawkins Cooker where the original thesis of buying the stock was for the dividend yield while the company's prospects for above average growth was realised only after the stock started to make its move in line with the move in all the consumer stocks.

In March 2009, I had bought and sold off TTK Prestige because I wasn't comfortable with the company's attempts at delisting itself and though I had bought a lot of beaten down names which had gone up, the stock price of TTK had also doubled up in this period. As the overall environment was tough and gloomy, the underlying fear of losing it all back compelled me to focus on the dividend yield before buying a stock and I was keeping a close watch on Hawkins Cooker which had moved up from its March 2009 lows of around ₹200 to around ₹350 by August 2009.

HAWKINS COOKER – THE DIVIDEND ACCELERATION STORY

	2009-10	2008-09	2007-08	2006-07	2005-06	2004-05	2003-04
Revenues (₹ Crores)	286	242	204	173	137	117	107
Dividend per share (₹)	40	20	10	7	5	3	1

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The company was generating very efficient return ratios and had been steadily increasing its dividend payouts in the backdrop of increasing margins. The past track record showed that if Hawkins would make profits it would distribute it as dividends. The company then declared its June 2010 results where even though sales increased by 23%, profits jumped by 68% as margins expanded all throughout because the price of their key raw material 'aluminium' had slipped post the Lehman collapse. Due to the asset light nature of the business, the company was generating a RoE of more than 100% and it was clear that any increase in profits would be incrementally distributed as dividends. At ₹350 the stock was trading at an yield of 5.5% on the basis of its latest dividend of ₹20 and a prospective yield of around 11% on the basis of its estimated dividend of ₹40. It is never easy to forecast the yield of any company but a company that has been generating super high return on capital without holding back cash had only one way to get rid of its excess earnings, which was to give it back to its shareholders as dividends.

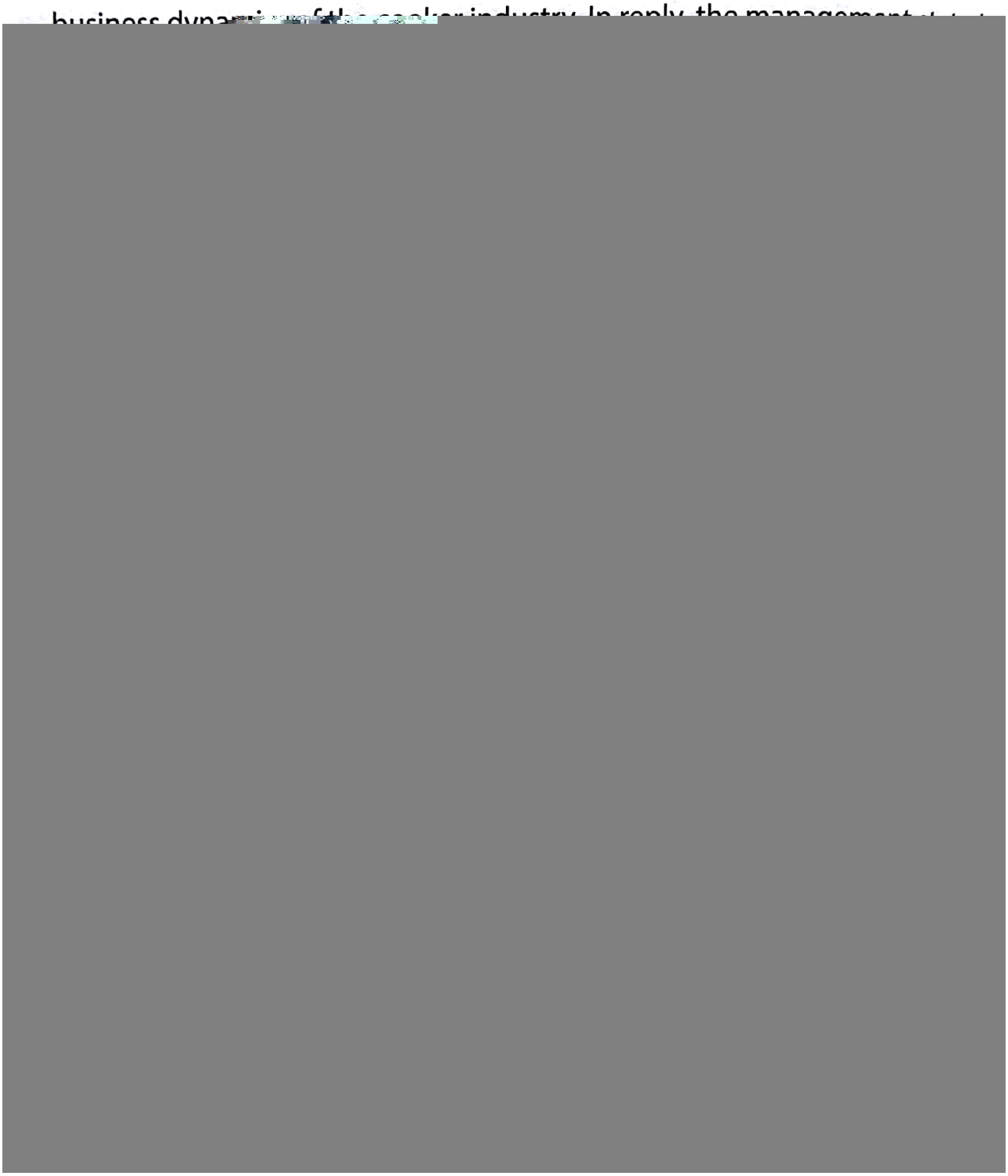
The company had declared a dividend of ₹20 per share for Fy 2009 and it was clear that dividend for Fy 2010 had a decent chance of doubling itself to ₹40 and even if the company did not double up the dividend in Fy 2010 it would do so by Fy 2011 as the stock was on a secular growth path. Irrespective of this, one thing was clear that the stock would not remain at such a high yield on its price of around ₹350 but sell for at around a 4% yield on a price of ₹1,000 even though the exact timeline for this remained undefined. The real question to grapple at that time was about the dynamics and the growth of the cooker industry as the replacement cycle was too long. But contrary to general opinion the company was unable to meet up to its demand as was evident from the annual report.

As I got ready to buy, I called up the company secretary at Hawkins asking for physical copies of the last few years of the annual report. However, the company secretary refused to send it stating that they don't send annual reports to people who are not shareholders of the company! Nevertheless, I bought a few shares and the stock started to move up as it was very illiquid but I had the comfort of yield which scored over the liquidity aspect of a stock so kept on accumulating the same.

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This behaviour at Hawkins was very strange to me as a few months back I had bought Page Industries and had similarly called up their company secretary for a copy of the annual report as also any investor presentation that they might have. The company secretary at Page not just sent me the annual report but also sent a CD with their IPO presentation. The lady had got the same copied from elsewhere as this presentation was deleted from her office computer.

Two contrasting attitudes from two companies in four months. After buying Hawkins I shot an email to their CEO with queries on the financials and the



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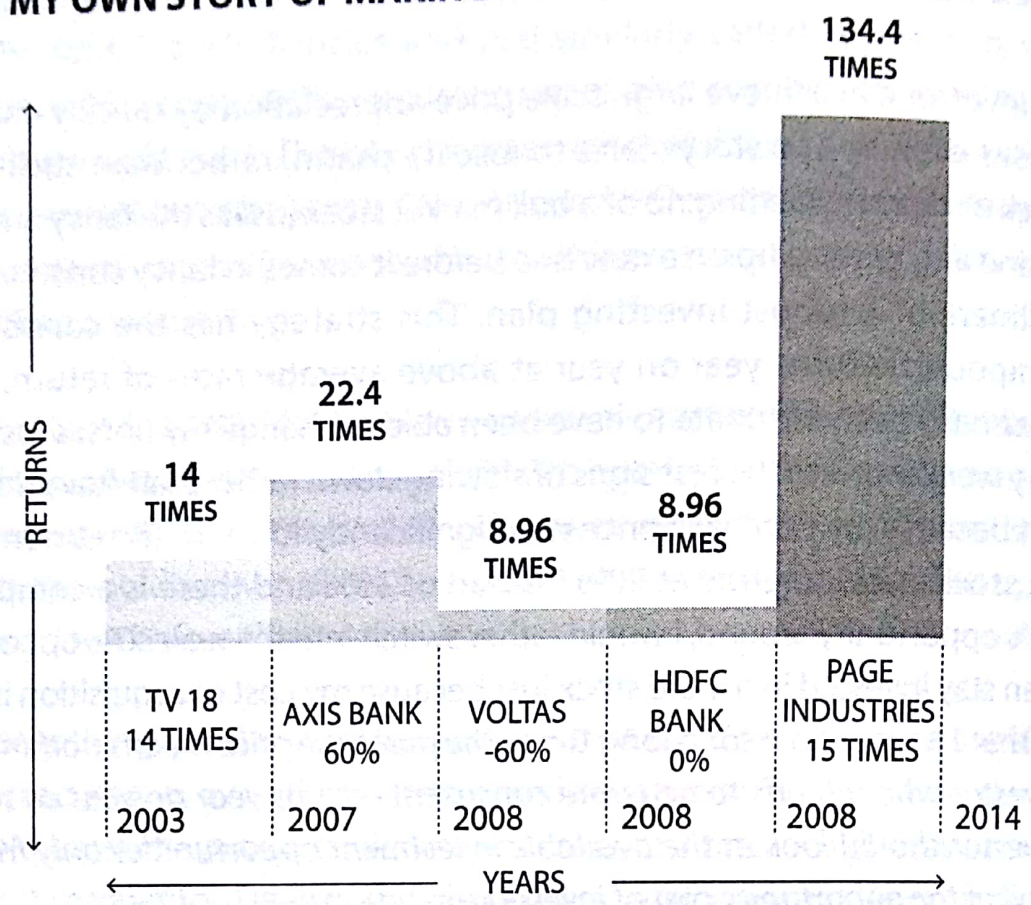
THE EFFECT OF MULTIPLE MULTIBAGGERS:

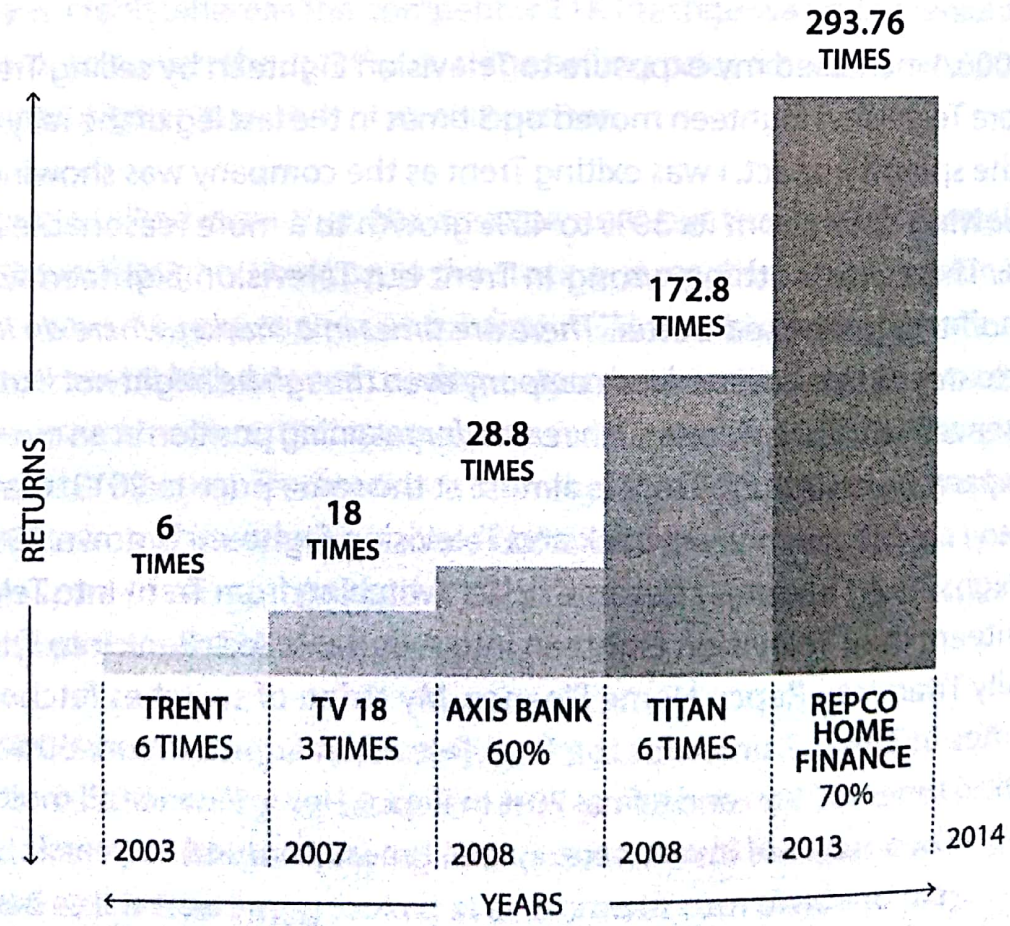
An investor can achieve large scale price appreciation by quickly changing horses even as one story starts to lose its charm, rather than stick to one stock till eternity. Getting rid of a bull market stock just as the fancy is nearing its end and getting up on a new one before it comes in fancy constitutes the hallmark of a robust investing plan. This strategy has the capability to compound returns year on year at above average rates of return. I have personally been fortunate to have been able to change my horses just when they were showing the first signs of slowing down rather than stay with them just because my purchase price was significantly lower to the current price. If a stock starts to grow at 20% instead of 35% and there is a comparable 30% opportunity around, I would rather switch into the new 30% opportunity than stay invested in my old stock just because my cost of acquisition is lower or that I have held it for a long time. *The purchase price means nothing to an investor who intends to generate consistent returns year on year as such an investor should look at the available investment opportunities only from the view of the opportunity cost of investing.*

In 2006, I increased my exposure to Television Eighteen by selling Trent just before Television Eighteen moved up 3 times in the last leg of the rally - aided by the spinoff impact. I was exiting Trent as the company was showing signs of slowing down from its 30% to 40% growth to a more reasonable 20% to 30%. There was nothing wrong in Trent but Television Eighteen with the spinoff trigger looked better. *There are times in a market where an investor has to stay with an overvalued company even though he might not like to.* The presence of a catalyst is one such reason for retaining position in an overvalued company. Even though Trent is almost at the same price in 2013 that it was when I sold it seven years back and Television Eighteen is down 90% from its highs; as an investor I became richer switching from Trent into Television Eighteen; then Television Eighteen into Axis Bank; Axis Bank into Titan and finally Titan into Repco Home Finance. My string of switches fetched me a 6 times in Trent; 3 times for the final Television Eighteen run; 60% in Axis Bank; 6 times in Titan and a final 70% in Repco Home Finance all multiplying up to take a rupee of investment up 294 times in around 11 years!

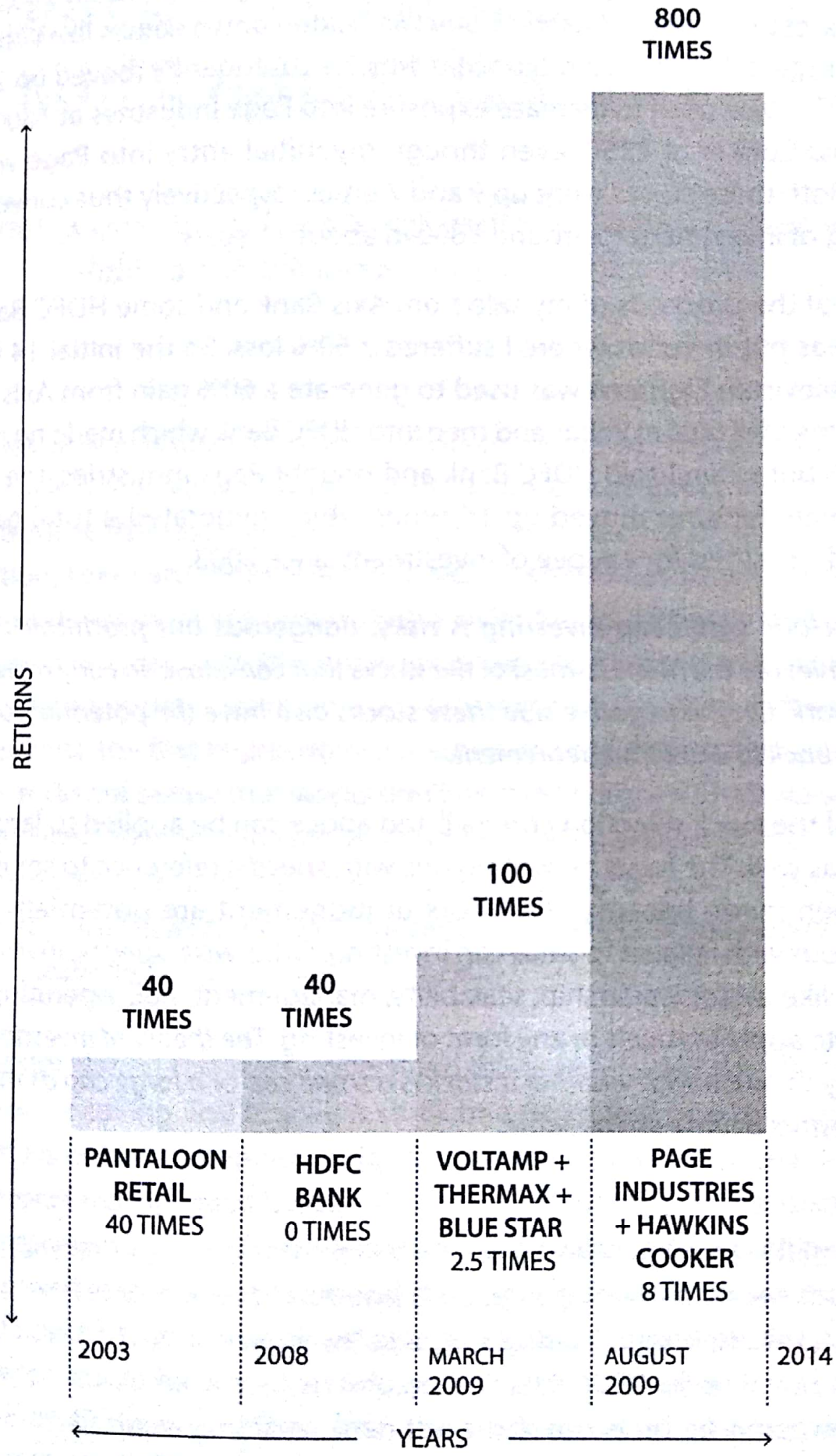
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MY OWN STORY OF MAKING MULTIPLE MULTIBAGGERS





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Similarly, my initial investment in Pantaloon Retail fetched me 40 times which then saw a near no profit no loss scenario in HDFC Bank during 2008. But the proceeds of this was used to buy the beaten down names like Voltamp Transformers, Thermax and Blue Star which subsequently moved up 2 to 3 times. This was used to increase exposure into Page Industries at ₹600 and Hawkins Cooker at ₹350, even though my initial entry into Page was at ₹350. Both these stocks went up 9 and 7 times respectively thus converting a rupee of investment to around ₹800 in about 11 years.

A part of the proceeds of my sale from Axis Bank and some HDFC Bank in 2008 was put in Voltas where I suffered a 60% loss. So the initial 14 times from Television Eighteen was used to generate a 60% gain from Axis Bank which then fell 60% in Voltas and then into HDFC Bank which made no return in 2008 but when I sold HDFC Bank and bought Page Industries, the inner wear manufacturer moved up 15 times which generated a total gain of around 134 times for a rupee of investment since 2003.

To conclude small cap investing is risky, dangerous but profitable. These companies are the home to most of the stocks that can cause an early retirement from work. On the negative side these stocks also have the potential to put a person back to work from retirement.

Most of the stock selection criteria listed above can be applied to large cap stocks as well. The focus on writing this with specific reference to small caps has been made because the errors of judgement are potentially more hazardous with respect to small cap investing. Otherwise, specific investment drivers like sector leadership, scalability, management, RoE, operating cash flows etc apply as much to any form of investing. *The theory of Investing does not vary so much with whether a stock is a small cap or a large cap as much as we investors debate on the same.*

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Chapter 29

WHEN TO CATCH A FALLING KNIFE AND WHEN NOT TO?

When a bull market ends, there are no falling knives only falling missiles, bombs and canon shells!

An investor who is keen on buying stocks of companies which he thinks are priced at less than what they are worth should look at stocks that are falling hard both with reason as well as caution. Irrespective of the perceived valuation, there are times when a buyer of shares has to withdraw from buying even as there are times when a seller has to withdraw from selling a stock. This is because the underlying current in the market is no less important than the overall fundamental value of the stock. When a bull market ends, the first impression it creates is of a big discount sale but most investors do not realise that stocks don't become bargains just because they have tumbled 50% from the top. *A stock that is falling because of forced market liquidation post a bull market top or a stock going up on panic buying before the bull run reaches its climax will in all probability go below and extend beyond what is the perceived fair value of the stock.*

An investor should therefore understand the broad market direction before he thinks of selling and buying a stock in a fierce bull or a ferocious bear market. Here the assumption of fair value should take a back seat because if the overall market trend is down then trying to bottom fish on stocks even if they represent a price which is less than the fair value will hurt. Alternatively, when a market is in a fierce uptrend then selling stocks because they have moved beyond their fair value will also be a losing proposition. For instance, an investor could have sold an Infosys in March 1998 when it was trading at a P/E of 49 times and then seen the stock move up 30 times over the next two years. Alternatively, one could have bought Infosys at its peak

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on March 08, 2000 and then seen it fall 50% and then 50% again. Similarly, in the year 2008, Unitech fell 80% and then fell 80% again because the fundamentals of the company gradually deteriorated which rendered the process of computing the fair value of the stock useless, each time a new negative event hit the stock.

The argument that an investor should buy stocks on a decline isn't as important as the argument as to what stocks he should actually be buying on a decline. To discuss the point further, we look at falling knives for three types of companies in the bear market of 2008:

a. **A high quality company in a low quality sector (Infrastructure) – Voltas**

b. **A high quality company in a high quality sector (Consumer) – Titan Industries**

c. **A low quality company in a low quality sector (Real Estate) – Unitech**

During the ferocious bear market of 2008 even as the entire market crashed by 60% the behaviour of different types of stocks to the overall fall was asymmetrical. A high quality company in a low quality sector (Voltas) saw its price move down to hit the bottom and then recover equally fast. In the case of a high quality company in a high quality sector (Titan) the fall stopped after the initial onslaught as the stock came to a PE ratio of around 25 for the current year whereas for a low quality company in a low quality sector (Unitech) the price drop was long, hard and permanent with the price refusing to move up even after several years of the story getting over.

A HIGH QUALITY COMPANY IN A LOW QUALITY SECTOR - VOLTAS:

Being invested primarily in retail (Pantaloon Retail) and media (Television Eighteen) stocks I had missed the entire infrastructure boom and jumped into Voltas in March 2008 at ₹180 after the stock had fallen 30% from its all time high. *An investor should realise that to make wealth all he needs is a few good ideas and not all the great ones with the courage to hold them through the length of the bull market. However, once the sector has moved past its prime*

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buying any stock from the sector, irrespective of its financials is bound to generate the same end effect. Sooner or later, great ideas become good while good ideas become mediocre and the mediocre ones become bad. What is great, good, mediocre and bad is answered in hindsight while an investor is expected to bet on these with foresight.

I had read about Voltas's 10x10x10 vision statement which reinforced my conviction in the story. The vision statement read that Voltas was targeting a revenue of ₹10,000 crores with a profit before interest and tax margin of 10% by Fy 2011. If this vision was met it was expected to generate an EPS of ₹21 for Fy 2011 which would have been discounting the price of ₹180 by less than 9 times.

Voltas started to fall right from the day I bought it at ₹180 and as it fell 20% it was clear that the markets were perturbed by the international economic situation and the flat order books. As Voltas generated a chunk of its orders from the Middle East the apparent fall in crude prices was an ominous sign for the wealth of the oil producing nations. The markets were sensing a slowing business while I was dreaming about the vision statement. The company was reporting decent growth with a very high RoE and was also generating free cash which was rare for infrastructure companies but I refused to believe the price action which was anticipating an overall decline in business and being a long term investor sometimes cuts both ways. Had this been a trading position, the stock would have been sold in no time but being a part owner of a business works against an investor when the story starts to move contrary to the way it was originally supposed to move as he refuses to let go of a losing stock in the backdrop of deteriorating fundamentals. *Just because he owns the stock the first thought for an investor is to take a long term view not realising that taking any kind of a bullish view for a cyclical stock which has just emerged from a five year bull run has to go wrong.* While it is correct for an investor to take a long term view thinking too long is bound to hurt when an investor is standing on a sinking ship.

As Voltas continued to fall, I refused to read the writing on the wall. The clear message was that infrastructure was the flavour of the previous bull run and an investor should avoid it. Other things come next. I used to take long evening walks trying to count the number of Voltas air-conditioners installed

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in the neighbourhood in a bid to increase my feel good about the stock. It was embarrassing to see house owners staring at me as I continued my hands-on experience of analysing the popularity of Voltas air-conditioners. I called up friends in Hyderabad to check out the rates in the area where Voltas held a large chunk of land. *The land angle was another addition to the research process just to make sure that the investor in me was correct in valuing the stock instead of the market that was pricing it.*

The foolishness of my research was that I was doing this to remain invested in a stock where I should have had no business buying in the first place. Air-conditioners were low margin items with cut throat competition and constituted less than 30% of the company's revenues and the company was getting its P/E not because of the air conditioner division but because of its project management and infrastructure businesses but when a stock that an investor owns moves down in price the analysis gets harder though the only analysis that would have worked in such a scenario was that the bull market for the sector in question was over and it was time to fold up - irrespective of the price.

As the stock slipped, I panicked because for the last several years I had never seen any of my stocks fall below purchase price. Taking a notional loss was hurting the ego and when I visited their AGM I came out convinced that the management would be able to pull it through. *The only issue that a losing investor does not understand is that when a company valued for growth sees a slowdown the only thing that can save the stock from going down is an increase in dividends as it happened to Hindustan Unilever Limited in the early part of the last decade. A high growth company rarely goes back to the high growth stage after it starts to slow down on the growth curve.*

I wanted to sell the stock when it went down to below ₹135 but the question of taking a 25% loss needed a little more courage and wisdom than I actually had. Slowly the stock moved down to 120 then to 110 and when it broke 100 it became very hot to handle but I refused to convert the notional loss into real pain. *The only reason why an investor does not let go of a falling stock is that by holding it he can hope for a price recovery but if he lets it go then he has to start all over again without any anchoring bias.* Though it is better to let go of an anchoring bias very few people succeed in doing so. When the

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stock moved down to below ₹90 I could take it no more and tried selling a little, the stock was dropping in round numbers now to below ₹80 and I let go all of it – in one stroke.

There was a curious sense of uneasy calm from the moment I sold it as *it is always a better feeling to see a stock go down after an investor has sold it than it is to see it rise after he has bought it.* I bought more of HDFC Bank at around ₹180 (split adjusted) and in a few days Voltas was fighting to stay above ₹60. When I had sold it at around ₹80 I had thought of buying it back at ₹60 but as it moved below ₹60 I got jittery and when Voltas moved to below ₹50 I removed it from my screen. I did not want to buy it now and not even see it. When it finally hit ₹30 I was convinced that this is heading for ₹10! I did not want to hear about it. The fear was maximum and the pain unbearable even though I did not own the stock. I did not know why every fall in the price of Voltas was hurting me. The price stayed at around ₹30 for a few days and though I was betting on Thermax, Bluestar and Voltamp for recovery, I did not want to buy Voltas again even though I knew that the investments and the Hyderabad property was a good percentage of the market cap. Voltas moved up quickly and swiftly and in no time it was up to ₹60 and then to ₹100. In the next 15 months Voltas moved back from ₹30 to ₹250 and then back to ₹80 by April 2013.

TITAN INDUSTRIES:

Titan Industries is another stock that I had bought in March 2008 after it fell almost 50% from the highs. My logic of buying Titan at nearer to ₹45 (adjusted for splits and bonus) was that it was a high quality stock that had already fallen 50% and while I thought that it might not fall too much it still slipped 20% over the next 12 months while the Sensex dropped 43% and the leader of the bull market Unitech slumped 90%. The fall in Titan's share price was arrested quite quickly as was evident from its behaviour in relation to the movement of other stocks as between October 2008 to early March 2009, Unitech fell 70% while Titan dropped only 11%.

The learning from 2008 with regard to catching falling knives was that the initial punishment for overvaluation is given out to both the high and low quality

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stocks. However, the high quality stock in a high quality sector stops falling beyond a point. Titan which was at a P/E of 50 times in January 2008 had fallen 50% by March 2008 to a P/E of 25 times at which point the stock stopped falling. So in case of a high quality stock it made sense to defer buying up to a point where valuations became reasonable whereas for a low quality company in a low quality sector it makes sense to completely avoid the purchase once the bull market has ended. *High quality stocks rarely become cheap so trying to buy them as bargains is a strategy that never works out as much as it is debated.* In the four years post the March 2009 lows, while the Sensex is up 2.2 times, Titan a high quality stock from a high quality sector is up 7.5 times, Voltas a high quality stock from a low quality sector is up 2.5 times and Unitech a low quality stock from a low quality sector is still struggling 40% below its all time lows of March 2009.

STOCK PRICE BEHAVIOUR OF THE GOOD, BAD AND THE UGLY

	7th January 2008	12th February 2008	18th March 2008	15th October 2008	4th March 2009	4th March 2013
Sensex	20812	16608	14833	10809	8446	18877
Titan (₹)	83	49	45	40	35	264
Voltas (₹)	249	177	163	68	33	82
Unitech (₹)	534	309	277	85	26	15

Titan fell 20% in the next 12 months after I bought it in March 2008, but looking at the overall market carnage it held out pretty well. On one side, there was a Voltas, which seemed to be making a big down move every month when compared to Titan and HDFC Bank which seemed unperturbed with the overall selling that was going around. Both these high quality companies used to report higher revenues and profits and as the earnings adjusted to new prices the P/E contracted to respectable levels.

Critics might argue that the 20% fall in Titan also made it a bad investment in March 2008 but the fact that the Sensex would almost be cut in half over the next 12 months was not an event forecasted by many. However, there

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were many investors who waited for clarity before buying and all of them were caught unawares when the markets started to rally from March 2009. Tops and bottoms are formed without much regard to fundamentals as prices at these turning points reflect the emotional aspect of the market participants so in most cases the stock either becomes a buy or a sell much before these turning points are actually reached. *The believers of a story generally get in early before the bottom and have to bear the pain before the gain. There* cannot *be any gain for someone who is unwilling to take the pain which indicates that an* investor looking from a purely fundamental angle should therefore buy a stock much before it hits the bottom. However, the overall character and nature of the stocks being purchased matters more than the price at which it is being bought for. Buying Unitech at any price in 2008 would have been a disaster as the stock lost almost 97% from its highs even as the earnings collapsed over the next four years. Similarly, buying a Titan would have been considered a reasonable effort as the stock rose in the backdrop of enhanced earnings flow.

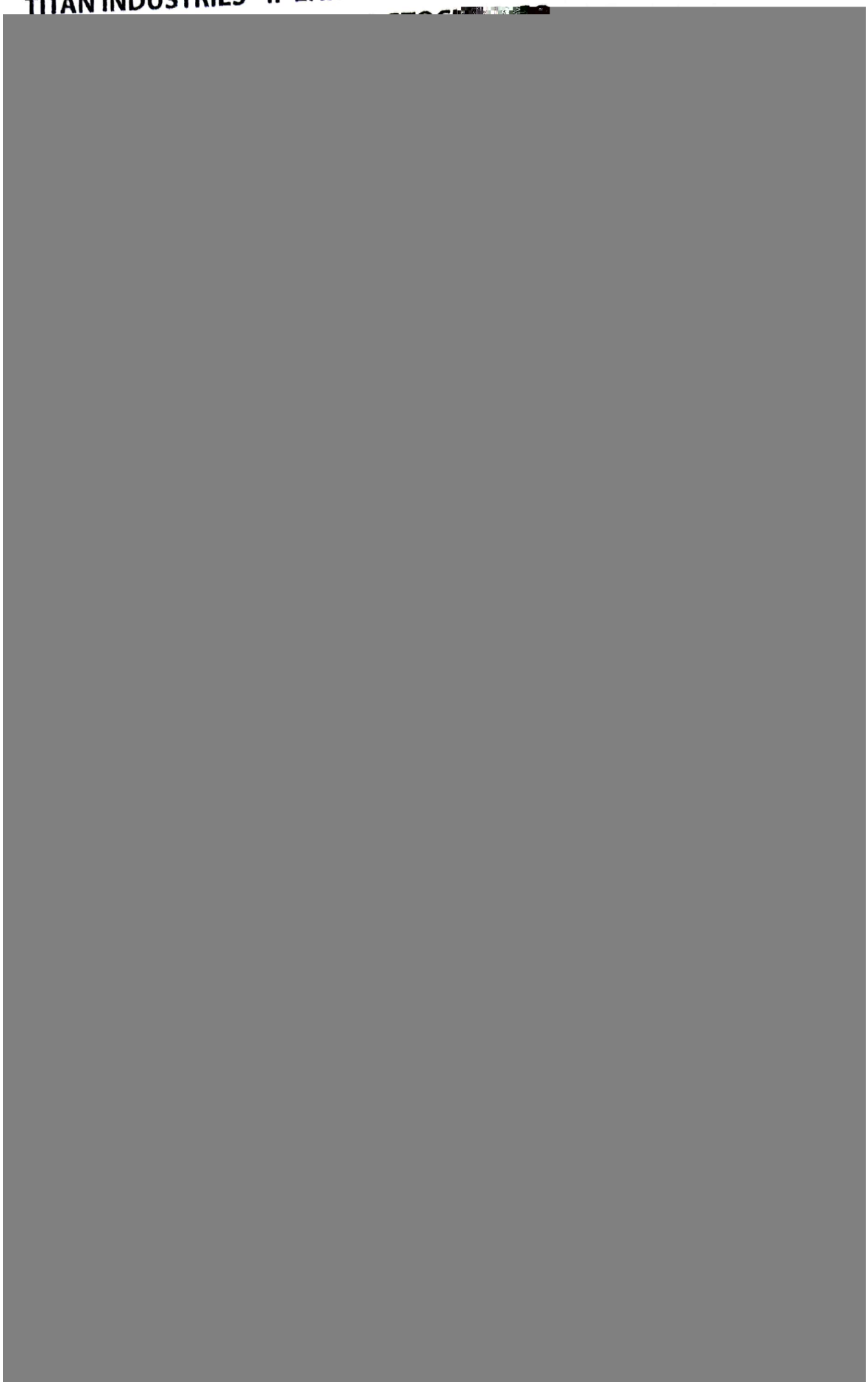
STOCK PRICES FOLLOW EARNINGS, EARNINGS AND ONLY EARNINGS:

The market wasn't wrong in knocking the stuffing out of Unitech and Voltas as the price was falling because the company's fundamentals were also deteriorating at a rapid pace. Compared to this, Titan's stock was resilient because its revenues and profits were increasing at an enhanced pace. If Unitech's stock price plummeted by 97% from the highs of 2008 its profit after tax also dropped by 87% in the intervening period. Similarly, in the case of Voltas the company's profit was still below what it generated in Fy 2008 and even though profits rose in Fy 2010 and Fy 2011 the same was reflected by the stock price which rallied up to around ₹250 before falling back just because the earnings just could not keep pace with the stock price.

If all stocks in an investor's portfolio are moving up at the same time and with the same speed, the market is probably nearing a top. Conversely, if all the portfolio stocks are moving down at the same time and with the same speed, the market isn't nearing a bottom because a bottom is reached when there is a calm after a panic whereas a top is reached in a phase of total euphoria. The charts on the following pages have the support of hindsight view but in reality if foresight was easy then it would not have been so remunerative.

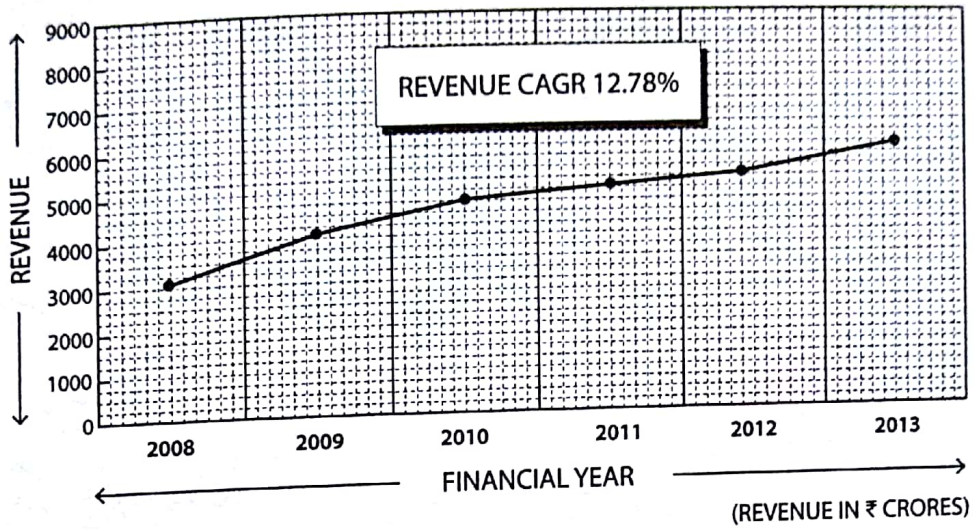
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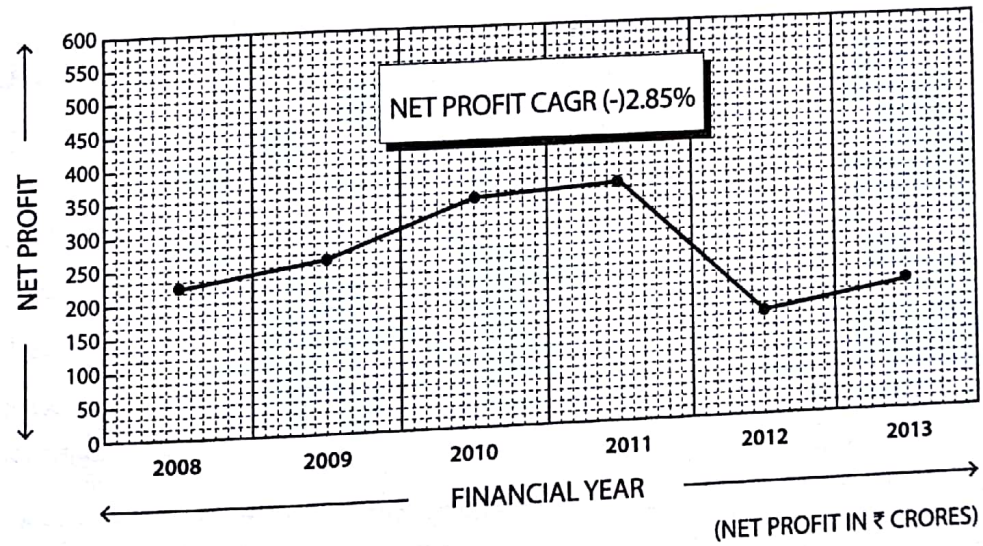
TITAN INDUSTRIES - IF EARNINGS MOVE UP THERE IS JUST ONE WAY

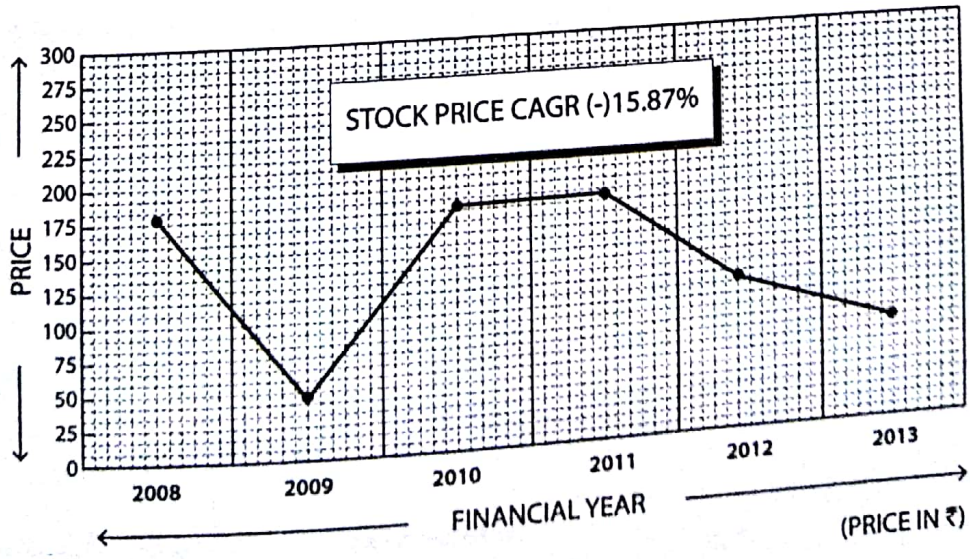


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VOLTAS - IF A COMPANY'S EARNINGS FLUCTUATE SO DOES THE PRICE

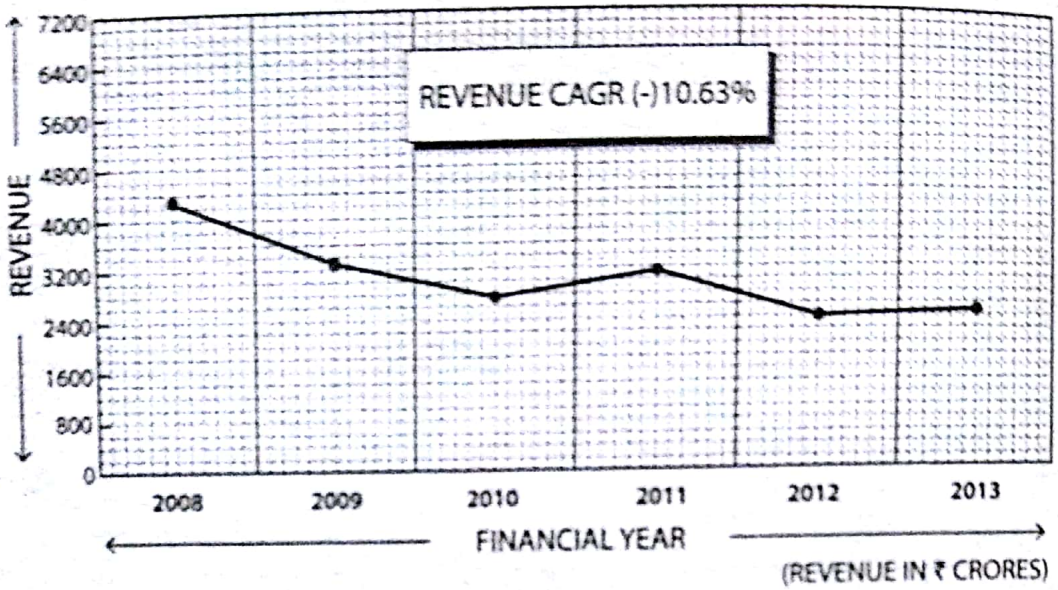


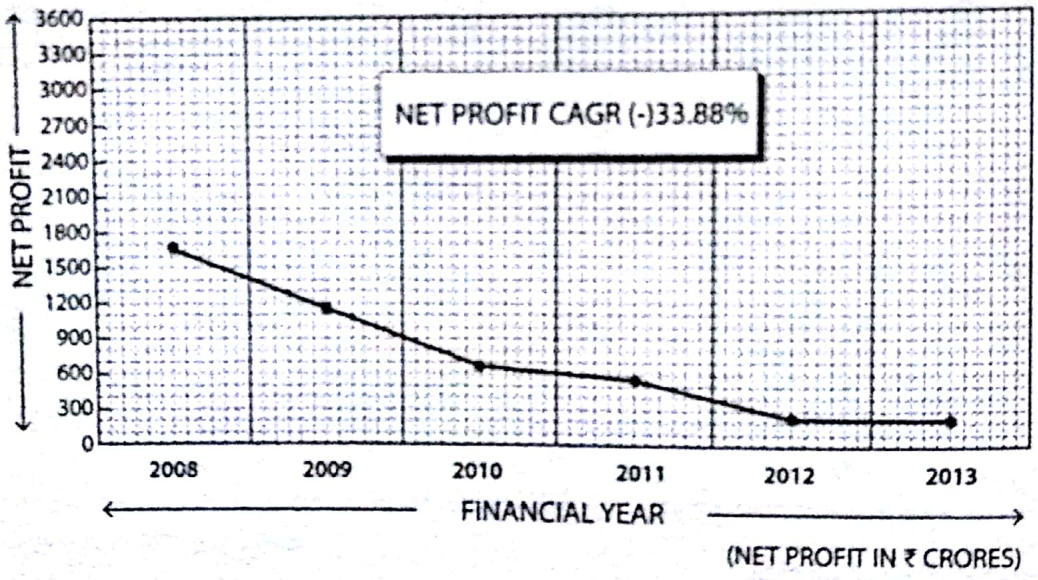


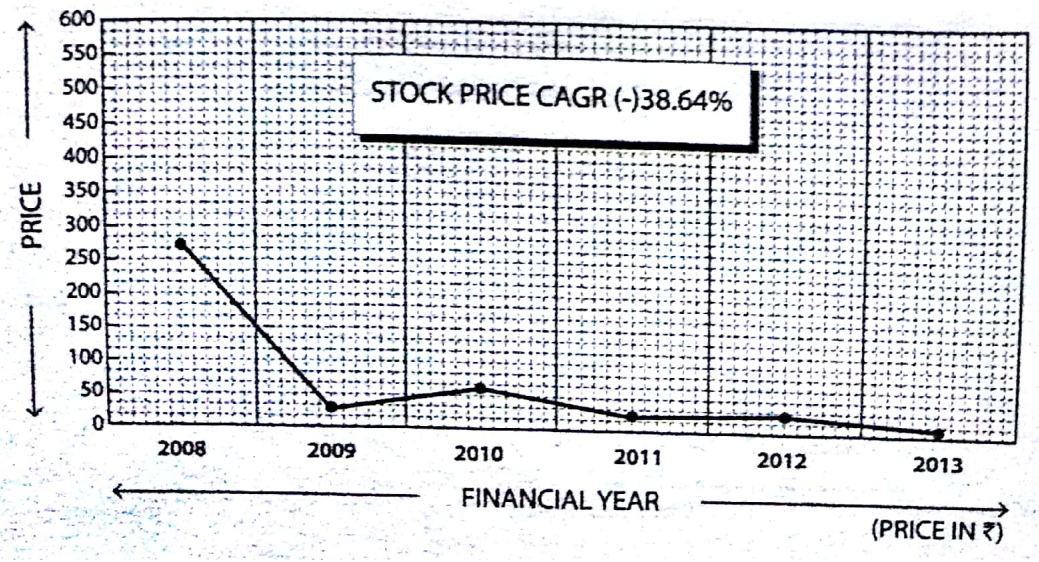


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UNITECH - THE STOCK PRICE FELL 97% BECAUSE EARNINGS ALSO COLLAPSED 80%.







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IN SPITE OF HIGH P/E, QUALITY STOCKS IN QUALITY SECTORS FALL LESS DURING A BEAR MARKET:

All stocks that come down are not falling knives but many are. In this case, the drift of Titan after I had bought it at a P/E of 25 times in March 2008 wasn't as ferocious to be called a falling knife when compared to the other two which leads me to believe that high quality stocks fall up to a point and then wait for earnings to catch up in what is called a time based correction. On the other hand, low quality stocks quickly move down the price chart compressing the price rise of the previous years in a matter of a few months. In certain cases of excessive overvaluation like Infosys (at a P/E of 322 in March 2000) even high quality stocks fall up to a point of reasonable valuation which in the case of Infosys was a P/E of 18 in September 2001. It is always easy to bring down a house than to build it up!

The market does not distinguish between the character of a business when it comes to excessive overvaluation as even Infosys fell 80% from its peak, during the technology bubble. The fall in Titan's price broadly stopped in March 2008 as the stock came down from a P/E of 50 times in January 2008 to a P/E of 20 times by March 2009, HDFC Bank's P/E dropped from 40 times at the top of the bull run in 2008 to 14 times by March 2009 and its price to book slipped to 2.1 times at the bottom in March 2009 from 5.2 times at the peak in January 2008.

The fall in valuations of Voltas was the most brutal where the P/E collapsed to 4 times earnings in March 2009 from 42 times at the peak of the bull run in January 2008. This P/E contraction came even while the company grew EPS by 21% to ₹7.63 from ₹6.3.

Finally, in case of a low quality stock in a low quality sector like Unitech the fall just did not stop as the fundamentals deteriorated with each passing quarter. Investors were not sure of the reported numbers nor were they convinced of a recovery anytime soon. *As every bull market will be followed by a bear onslaught an investor looking for bargains should remain focused on the initial part of the fall on either a high quality stock in a high quality sector and later on a high quality stock in a low quality sector.* A sector that has

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emerged out of a bull market can be construed to be low quality for this purpose but irrespective of valuations an investor should always avoid a low quality stock from a low quality sector because the potential damage remains the maximum with such kind of stocks.

Catching a falling stock is not always the same as catching a falling knife.

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Chapter 30

THE ONES I SAW AND MISSED

An investor who always regrets his misses is like a person who repents about every girl he saw but did not marry!

Most stock market participants prefer to share their success stories while only a few share their regrets. These regrets could be of a stock that they bought and lost money on (miss hit) or a company that they missed buying and did not make any money from even as the stock ran up multiple times from the price they first saw it at (miss). Overall, an investor will theoretically have more misses than hits because while constructing a portfolio he would hardly be buying 0.25% to 0.5% of all 7,000 listed stocks so the odds of having a miss will be 400 to 200 times more than the odds of making a hit. Clearly, to lower the regrets of a miss an investor would need to buy as much of the 7,000 listed stocks but increasing the number of stocks will reduce his performance and bring it in line with the broad indices. So an investor who intends to convincingly beat the market should be prepared for a few hits and a string of misses.

An accomplished investor who follows a disciplined investing strategy will have more misses than hits as his core investing strategy would restrain him from buying any stock on the street. *But as long as he makes more from the hits he should not be complaining about the ones he misses. Curiously though, most participants remember only those misses that go up in price whereas a miss which eventually under-performed or went down the price chart is in fact a hit as avoiding losers constitutes an integral part of a robust investing strategy.*

Though I have never regretted from my misses I keep a tab on them just to see if I can learn anything from those errors of judgement. While I have been involved with markets since the Harshad Mehta days of 1992 my real phase of investing came after I lost almost my entire capital in 2001. Prior to that,

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I was just a part time stock market enthusiast who was only making money to lose it back again.

The list of misses could be endless as any stock that moves up before an investor could buy it can be categorised as a miss but I have only talked about the stocks I saw in some detail but did not buy for reasons that seemed genuine at that time.

UNITED SPIRITS:

My first known regret was United Spirits when it used to trade at ₹40 in 2002. Though liquor is a phenomenal business and looks quite similar to the cigarette selling business of ITC, I remained uncomfortable with Vijay Mallya's style of management but still bought the stock at around ₹40 and sold it back at about a 10% gain because I wasn't sure as to how the company would move back to an era of reporting normal profits. McDowell, as the company was called at that time was locked in a bitter battle to takeover Shaw Wallace which it eventually did and the stock responded by moving up 50 times over the next six years facilitated more by a P/E expansion than by earnings growth.

Lesson: I learnt no new lessons as given an option even today I would rather miss a profitable idea under a shady management rather than risk making money betting on one. *Buying a great business under a questionable management is as ineffective as buying a bad business under a great management as while the latter will not let it die the former will not let it live.*

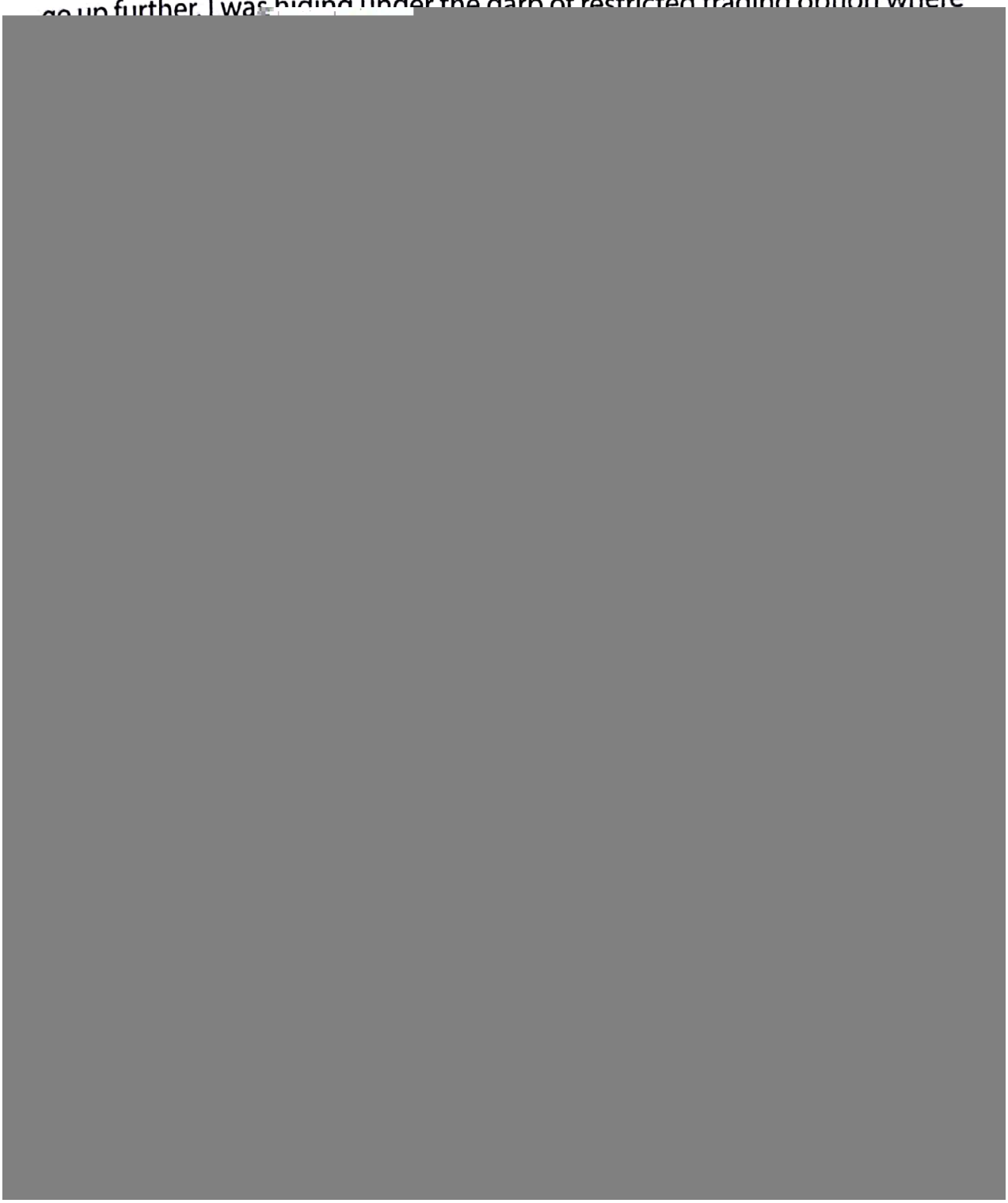
NAGARJUNA CONSTRUCTION:

My next big miss was Nagarjuna Construction in 2003 after it had rallied 50% from its price of ₹3.50 (adjusted for splits and bonus). There was a small flurry developing in infrastructure stocks and Nagarjuna seemed to be a good investment at a market capitalisation of less than ₹200 crores and growing at around 40% year on year but as I tried putting the stock on my online trading platform it refused to load up. I was later informed that due to liquidity reasons my broker, Kotak Securities did not allow Nagarjuna Construction

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as a trading option for its online clients. Desperately, I tried to look for a new broker to buy the stock and called a friend to check if he would help me open an account somewhere. The stock however moved up 15% over the next few days and being anchored on a specific buy price I refused to buy. Over the next 5 years Nagarjuna moved up 55 times.

Lesson: Just because a stock has moved up does not mean that it will not go up further. I was hiding under the garb of restricted trading option where



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have, as the stock quickly moved up 30%. The price anchoring bias within me along with the losses that Bharti was making at that time restrained me from going all out. This mistake cost me dearly over the next 5 years as Bharti eventually went up 50 times from those prices of 2003.

Lesson: *It is now obvious that trying to buy a great business for what it is actually worth and not a little more can do more damage in the long run than what it seems at first.* If Bharti's losses were putting me off I could have bought it later when the company had moved into profitability. *My misery was compounded because I refused to understand that it is never too late to buy a good stock or sell a bad one.*

TITAN INDUSTRIES:

Titan came in next on the list. As I was invested in the retailing companies I was convinced about the prospects of Titan. I bought the stock in 2003 and then sold it back to buy Television Eighteen just because I thought that Television Eighteen would do better than Titan as the jewellery business at Titan was yet to break even. In hindsight, Titan was a more robust model with better cash flows and a scalable business and the stock moved up 9 times by early 2008, while in almost the same period Television Eighteen had moved up 14 times.

Lesson: While I was fortunate to have made money in Television Eighteen the overall method of choosing the stock was wrong because Television Eighteen was just a bull market stock. I was holding Television Eighteen because it was showing an annualised growth of over 40% till 2008 but ultimately it is the opportunity cost that matters. Even though there should be no regrets, my stock selection process should have been better because the risks of growing an investment 14 times in Television Eighteen was a lot more than the risks of seeing a 9 times price increase in Titan.

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GRUH FINANCE:

I have been looking at Gruh Finance ever since a friend recommended it to me in 2003 but I jumped into it several years later as the 25% annualised growth did not make Gruh special in the 2003 to 2008 era as there were several other companies growing at 25% at that time. Gruh moved up 6 times between 2003 to 2008 and then another 7 times from the top of 2008 and though making 42 times in a stock looks a lot better than making 7 times the opportunity cost of investing in Gruh prior to 2008 was high, as by 2008 Gruh had done only as well as the Sensex.

Lesson: No new lesson, just the old one that opportunity cost matters and irrespective of the company and the very long term view an investor should just focus on the stocks as relative investment opportunities and not as absolute bets.

EDUCOMP SOLUTIONS:

In 2006, I was super bullish on Educomp, a company with inferior financials which was generating above average growth. I had a very small interest here and also booked out very soon because I wasn't too enthused about the business model and the frequent equity dilutions that the company was undertaking. The stock moved up 5 times over the next 18 months from the point of my sale.

Lesson: There were no lessons learnt here. The stock was a bull market wonder and given another option I would like to miss an Educomp rather than buy and risk permanent loss of capital. An investor has to remain focused on his investment strategy all the time even though chasing returns will be beneficial one day, it might become more fatal the next.

TTK PRESTIGE:

A stock which I bought in March 2009 and sold back the next day was TTK Prestige. As soon as I bought an initial quantity in TTK, I discovered that the management had wanted to delist the company as its market cap was less

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than the value of the land at Bangalore. TTK has moved up 35 times from that point. While many investors like buybacks I personally don't like companies that delist their stock because most delistings come just ahead of a secular growth phase which robs the old and loyal shareholders of years of assured growth. Given an option in making 25% for the next ten years and 30% in the first, I would always chose the former as my investing strategy has been built on the thesis that compounding returns over longer periods of time is always better than generating a one year market outperformance. I had held E-Serve and regretted the way in which it was delisted just as its BPO business had started to do well which forced me to sell rather than participate from the booming prospects of its BPO business. With this thought in mind, I sold back TTK Prestige immediately after I had bought it.

In this backdrop, it is important to indicate that sometimes a promoter might go in for a merger instead of a buyout. In such a scenario, most retail investors look to buy the stock that is at a lower absolute price. The promoter however, will set the ratio in a manner that gets it the maximum advantage and one way of finding that out is to look at the promoter holding of the two companies being set up for a merger. The ratio will invariably benefit that company where the promoter has a higher percentage of holding.

Lesson: *Having a single notion in the stock market never helps, I exited TTK just because the company had attempted to delist the stock. As a long term investor it pays to take a long term view but not overdo it.*

JUBILANT FOODWORKS:

Jubilant Foodworks which owns the master franchise of the Dominos pizza chain in India came out with its IPO in 2010 but as I was already owning Page Industries, a franchise company I did not buy Dominos as I did not want two franchise companies in my concentrated portfolio and to compensate for this I bought more of Page instead. Even though Page outperformed Jubilant in the next four years, Jubilant will theoretically go down as a miss.

Lesson: My apprehension in Jubilant about the cancellation of its franchise agreement was normal but equating that cancellation with Page's license

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was a little out of place as these two events were mutually exclusive, a case where one cancellation has no bearing to another and though I missed Jubilant, the learning was to remain focused on a stock rather than get bothered about unrelated connections in the portfolio.

KAVERI SEEDS:

Kaveri Seeds was again a company that got on my list of misses because of my preconceived notions that understanding companies with intellectual property rights was always a challenge. The stock at ₹400 (pre-split) in 2011 traded at single digit multiples and had also established its cotton and hybrid corn seeds in the market. My problem with Kaveri was not about growth but of understanding the business. Over the next 18 months the stock was up 4.5 times.

Lesson: *If the financials are good and the business debt free with a high RoE and the company promises above average growth one can buy a little without trying to understand a great deal about the business.* A debt free business with high RoE is the first signal to a robust business model but as by nature I am more of a large bet player I restrained myself from taking even a smaller position. *I learnt later that a person learns more about a business after he has bought the stock than he does before buying it.*

Though it is a common practice to worry about the misses in the stock market as it is to flaunt about the returns, the misses for a successful investor will always exceed the hits. However, as long as the objective of generating a long term portfolio growth is being met there is no need to worry over the misses.

Markets are like a river and opportunities come and go like flowing water. An investor should understand that missing an opportunity isn't necessarily the end of the world for him because another one will come much sooner than what he expects it to. If someone missed buying cement stocks in the early 1990's then he could have bet on the technology companies a few years later, if he missed the technology boom he could have bet on retail, construction, mobile telephony and real estate in 2003 and if he missed this there was a

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rally waiting to happen in the consumption, pharmaceutical and private financials space in 2009. *The stream of opportunities will always be infinite but what is finite is the money that chases it. Each of these investments comes with an opportunity cost of not buying another competing investment* so if an investor bought Gruh and missed buying HDFC Bank he did not become poorer by not buying HDFC Bank because the difference was only to the feel good factor of having made one more profitable investment.

The pain of missing a profitable investment like HDFC Bank comes only when an investor allocates capital to a losing stock which subsequently falls in value. *Talking about a stock that an investor saw but did not buy makes no difference to an investor's balance sheet and should therefore not be a part of his thinking process except to draw any learnings out of it. A disciplined investor who is consistent with his high standards of stock evaluation will always have a string of misses that will exceed his hits but missing a stock does not matter if the overall portfolio did as much as it would had he not missed an idea and if the portfolio did not do well - then there will be another opportunity coming soon.*

In investing as in life, it makes sense to keep looking ahead all the time because things without remedy should always be without regard and there is just no remedy for a miss that has happened in the past except to make it up with a hit in the future.

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Chapter 31

WHEN TO SELL AND WHEN NOT TO?

Love your family not your stock.

The best time to sell a stock is just before it starts going down! On a serious note it is difficult to time the turning points and selling a stock is more a function of educated guesswork than a decision based out of a formula driven process. One of the most important reasons for selling a stock is because the investor has found a new opportunity better than the one he actually holds, but a few more reasons of selling a stock are extended valuations, a bull market sector losing favour, change in the original thesis either due to management action or an adverse government regulation, advent of a new competitor, general business slowdown or increasing portfolio skewness due to movement in the price of a specific stock.

It is apparent that when it comes to selling a stock one has to have a different yardstick. Selling a bull market leader will be different from selling a stable compounding machine which in any case will be different from selling a dividend yield or a cyclical stock but an investor who does not know the art of selling, irrespective of whether he is in a profit or a loss will find it tough to make money from the markets and even more challenging to retain what he has made.

OPPORTUNITY COST:

One of the thoughts that an investor should use in evaluating a stock is to look at it from the relative point of view and always equate the cost of owning a stock as the opportunity foregone by not buying another one. This is because money is finite in the context of the overall investing opportunity and hence any attempt to prioritise investments based on the relative options

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foregone is a reasonable tool to adapt. Personally for me, investing is all about the opportunity cost. So even though I had bought Titan as far back in 2003, I had sold it to buy Television Eighteen which looked better at that time. There was nothing wrong with Titan in 2003 but the opportunity in Television Eighteen seemed better. The final result till 2007 was a little more in Television Eighteen even though both stocks moved up several times in the intervening period. So when I sold Television Eighteen in 2007 and switched to Axis the rejig finally brought me back to Titan again - five years after my initial purchase.

In March 2009, I had bought beaten down stocks like Voltamp Transformers (₹350), Thermax (₹165) Blue Star (₹140) etc which quickly moved up in less than six months. However, from that point onwards it seemed difficult to make further money from these stocks and as I liquidated my cyclical basket Voltamp got me ₹750 whereas Thermax and Blue Star were disposed off at ₹440 and ₹400 respectively. I had very little clue that the temporary rise in prices of these stocks was just a bounce and not a restart of a new trend but the opportunity in Page Industries looked better even though it had moved up from my initial buy price of ₹350 to ₹600. I also initiated exposure to Hawkins at ₹350 as it was a potential case of dividend re-rating. I bought Hawkins even as it was up 180% from its October 2008 levels of ₹160 but the future looked brighter with these two consumer stocks than with the industrials and hence the switch. Four years from then the cyclicals are collectively down 30% from the price I sold it at while Page and Hawkins are collectively up around 800%. All this happened because I used the opportunity cost method of evaluating stocks.

WHEN THE PRESENT DISCOUNTS THE GREAT FUTURE:

As we have discussed before in case of a multiple year sector led secular bull run, the leading stock of the sector will extend both in price and valuation as long as growth is intact. In other words, a company growing at 30% CAGR will see its P/E at 30 to 40 times for the entire length of the growth period. However, if the growth were to falter to say 20% then this company will be derated to a new valuation matrix.

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In case of individual high growth companies that are not a part of the overall sectoral bull market the P/E ratio does not move into the stratosphere but starts correcting on the first signs of excessive overvaluation. The extended valuation on today's high growth has to be thus equated with the normalised P/E of the coming years. Just Dial, the localised search business company currently trades at ₹1,350 which is a P/E of around 90 times its estimated Fy14 EPS of ₹15, so if the company were to grow earnings at 40% for the next five years and then slip to a growth of 25% its EPS in the next 5 years would reach ₹80. Now if the P/E slips to 25 due to a slower growth, the price would be ₹2,000 giving out an annualised return of only 8.1% in the interim. Alternatively, if the stock grows at 50% CAGR for the next five years and the P/E drops to 30 for a growth of 30% thereafter an investor would make an annualised return of 20.4% over the five year period. The risk reward in stocks with an extended valuation is quite unfavourable to an investor unless he has reasons to assume this supernormal growth to continue for longer periods of time. On the positive side, these stocks do not experience a deep price correction if the market can remain convinced about the steady growth in earnings ahead, even though the anticipated growth is 'slightly' lower than the previous one. The operative word is 'slightly'.

Now everyone knows that all companies have to hit a growth slowdown sooner or later, a growth slowdown for a fast growing company is as certain as death to a human being, the timeline of which remains undecided though. In this case, an investor should choose to make a 20% return elsewhere rather than run the risk of sticking to stocks in a high growth phase with the risk of a lower growth, somewhere in the distant future. In the example above, we have assumed Just Dial to deliver an annualised earnings growth of 40% to 50% for the next five years and then a 25% to 30% growth thereafter, which itself is an aggressive assumption to make.

However, if Just Dial continues to grow at 40% for the next ten years or does not see a valuation compression (because it uses the free cash to distribute dividend) then it would be a different outcome altogether.

This is for individual high growth companies but if the overall sector is in a bull run as indicated before, then one should not pre-empt but wait for the sector to show the first signs of topping out. Thus there is a difference in treatment of

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a stock, depending on whether it is part of an overall bull market sector or just an individual stock making new highs.

SECTOR LOSES FAVOUR BEFORE ENTERING A LOW GROWTH REGIME:

If the stock is a bull market leader then either the stock will be sold too early in the rally or will be held till its too late. *Almost everyone holding Infosys could not sell at the top in March 2000 but to make a lot of money from stocks it isn't necessary to sell at the top as it is not essential to buy at the bottom either.* The problem arises not because investors do not sell at the peak but as the bull market folds up, new investors get sucked into falling prices. A stock available at ₹4,000 after hitting a high of ₹5,000 always seems more attractive than a stock that is at ₹4,000 on way to ₹5,000.

If a sector has lost favour and moves into a lower growth regime, an investor should cash out immediately rather than wait for a bounce to get a higher price for his stock. But the fact that a sector has lost favour and is ending its high growth phase will be known only after the stock has fallen 30% to 40% from the peak. However, as the last leg of any rise is fast and vicious, this fall from the peak would in any case be just a move back to the three month old prices. Moreover, if a sector is on way to extreme overvaluation it is prudent not to pre-empt the top before it actually happens because the top could be significantly higher than what anyone can predict in foresight. *To repeat, an investor should make a distinction between a stock rally and a sector rally because an investor should let his profits run if it is a sector led bull run like it happened in 1992, 2000 and 2008 than if it were just an individual stock rally in which case it is logical to start selling on the signs of excessive overvaluation.*

The first step to do when a sector is entering the zone of extended valuation in a raging bull market is to sell the low grade stocks for the leaders even if the leaders are relatively expensive and then after it is clear that the bull market has ended one should sell the leaders as well. Here an investor should not get glued to past prices and wait for recovery. But if the stock price recovers towards new highs and goes beyond, it would signal that the bull market hasn't ended but continues unabated.

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As argued above, a cautious investor should always look at changing the structure of the portfolio in such times by substituting the inferior companies with the superior ones. For instance, towards the end of the 2000 bull run, an investor should have sold Mastek and bought Infosys, in the 2008 bull run he should have sold Hindustan Construction and bought L&T and even though the valuation of Infosys and L&T would have been significantly more than that of the companies being recommended for a switch the pain of falling prices is relatively lesser in the leaders than in the second liners. *Of course, there was no substitute to selling all software stocks in 2000 or construction companies in 2008 but even if one were to get caught in a down move it is better to fall with the leader than struggle with the laggard.*

Even after fourteen years of the 2000 tech bubble, investors are still making two times from the peak price of Infosys and are down more than 40% from the 2008 highs of L&T whereas the loss from the peak price at Hindustan Construction and IVRCL even after 5 years of the fall is still 95% each. Even though the example of losing money on Infosys at above 300 P/E in 2000 is used by thinkers and the analyst community quite frequently, they fail to highlight that the relatively cheap second liners have caused far more devastation than the super expensive leaders. At least the leaders recover the capital for their owners but in that case one has to focus on leaders with an honest management as though the capital recovery for the 2008 investor of L&T looks possible but the same for the then investors of Unitech is next to impossible.

CHANGE IN THE ORIGINAL THESIS EITHER DUE TO CHANGING BUSINESS FUNDAMENTALS, MANAGEMENT ACTION OR A GOVERNMENT REGULATION:

Sometimes a stock needs urgent action because of a change in the original thesis under which it had been purchased. Many times an investor is introduced to a new negative aspect in the fundamental attribute of a business by which time the stock could also fall below his purchase price but if the original thesis has been disturbed then an investor should exit the stock, irrespective of whether he is making money out of it or incurring a loss. *The future always remains uncertain and is to a large extent unknown, so a company with excellent prospects could suddenly encounter a situation of*

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deteriorating business fundamentals in which case an investor is expected to take serious and immediate action - irrespective of his purchase price.

Not selling a stock with deteriorating fundamentals just because the market price is below an investor's purchase cost is the worst of all possible reasons to hold onto a stock. An investor who is not keen on taking a small loss in spite of a change in the economic set up of his stock generally pays up with a bigger one.

I faced the same dilemma in March 2009, when in my quest to look for the beaten down names I had bought Crompton Greaves, at around ₹127 as a valuation call. No sooner had I bought it there was a company announcement about the management's decision to buy a 41% stake into Avantha Power, a group power venture company for ₹227 crores which was enough of a reason to force me to exit the stock immediately thereafter, at a 3% loss. The original thesis was to buy a capital goods company and not a business which passively invests its excess earnings into a low return government regulated, power company.

A company that does not like to retain cash will look at new ways to spend its cash off. A couple of years later Crompton was again in the news, this time for having bought a private jet for ₹270 crores!

It takes a lot of courage to sell a stock that has seen a change in the original thesis either due to a change in business environment, deteriorating management integrity or a negative government regulation. *The first impulsive thought under such a situation is to passively wait for a positive event whereas the need of the hour is to become active and take a decision, if the change in thesis is significant or stay put if it isn't. A question to ask in such a situation is whether an investor would have bought a stock had he known about this new found negative development or he is sticking to it just to justify his earlier buy decision because remaining invested seems a better deal than not taking a loss.* I had earlier ignored this strategy when I had bought Voltas where despite the deteriorating fundamentals I continued to hold the stock which ultimately had to be sold at below 60% the purchase price.

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MY OWN STORY - ZYDUS WELLNESS AND TITAN INDUSTRIES:

I faced this dilemma in Zydus Wellness a stock that I bought at around ₹260 in early 2010. Zydus was a consumer company manufacturing 'Sugarfree' (low calorie sweetener), 'Nutralite' (low cholesterol margarine) and 'Everyuth' (beauty products). The company continued to grow strongly, reporting a 30% revenue growth and the stock responded by doubling in around 15 months to about ₹500. However, the slow growth in Nutralite was worrying me even as the stock continued to perform well on the price front. The management later clarified that Nutralite generally grows at 15% to 20% and experiences faster growth only when AMUL undergoes supply slippages. This was the first rude awakening for me as my original thesis was to assume Nutralite to be a 25% grower which it was growing at after I had bought Zydus, as AMUL was then on strike.

During that time, HUL the big daddy of the FMCG market started positioning its 'Fair and Lovely' face-wash in a very unique way. It advertised that users are more likely to get fairer if they used the 'Fair and Lovely' cream with 'Fair and Lovely' face wash. Meanwhile, Everyuth, Zydus's beauty brand was experiencing a rough patch with slowing sales. To maintain profits, the management had cut down on advertisement spending and even though profits were growing at 25% the revenue growth remained lukewarm. *Cutting advertisement spending to a consumer facing product is like reducing insulin to a person suffering from chronic diabetes.* To make matters worse, the company cut distributor margins to bring it in line with the overall industry levels which also acted as a dampener on sales. *The company had therefore managed to increase profits even through revenues continued to remain sluggish. A small cap with slowing sales growth and rising profitability is more a case for concern than a small cap with growing sales and a temporary aberration in profitability.*

In 2011, the company launched its fourth product ActiLife, a nutritional health drink positioned for adults. ActiLife was expected to be a game changer for the company as adults in India were hooked to Horlicks and Bournvita. The stock continued to move as profits rose helped by a cut in advertisement spending even while sales growth remained lacklustre. Though the product was launched I could not find any of it near my locality, a fact that I pointed

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out at the AGM. The company quickly sent me two bottles of ActiLife with its eastern India office bearers to my home the next day. In the conversation that ensued, I got an indirect sense that ActiLife was still a very young product and that I was extending myself too much into it. Even the distributor feedback indicated that ActiLife was not selling well and it seemed that Zydus would probably hit a temporary air-pocket and for an equal valuation I had stocks like Page, Hawkins and Titan. The stock meanwhile had moved up to ₹750 and was then slipping back to 650. I used the opportunity to offload not because there was anything seriously wrong with Zydus Wellness but because the other stocks seemed better especially in light of the change in the original thesis, a strategy that was later vindicated as Zydus went nowhere for the next two years even while in this period Page and Hawkins doubled with effortless ease.

A couple of years later the RBI restricted jewellery companies from taking gold on lease. This decision had adversely affected Titan Industries, a stock that I was holding since 2008. The stock now almost six times to my buy price was facing a threat to its low capex busines as its earlier model of borrowing gold was now withdrawn by RBI and the company would now have to put upfront cash to buy gold. The news hit the market on 11th June 2013, at around 1.30 pm and the stock slowly started drifting down from ₹255. Even though the repercussions were clear at that time an investor is never eager to accept a negative change, especially if it comes with respect to a company which he has been holding for five years and is up almost 6 times from his buy price. *The biggest misconception of margin of safety is a lower purchase price even though a purchase price has nothing to do with an investor's current strategy which should always be dependent on the current circumstances rather than his historical cost of purchase.* The stock price was slipping by a rupee every few minutes and it was a tough decision to make. The company was conducting a conference call and a few minutes into it was enough to understand that the golden period of Titan Industries was behind it. The price had by then fallen to ₹242 and there was no time to think. I called my brokers and reluctantly asked them to start selling. By the end of that day, I had sold some 40% of my holding as the stock dipped to close at ₹226 the lowest point of the day.

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A stock that closes on the lowest point of a day in the backdrop of a negative company specific news generally opens a lot weaker the next day and even though I had seen this happen for so many years I was really unsure of my selling decision. A stock that has been held for five years cannot be offloaded in a few minutes as an investor needs to spend at least a night in pain, agony and distress thinking about the same before he can gather all his wisdom to take the correct decision. By early morning, it was clear that I could bear no more of it and would have had to let go of the entire thing. I was so desperate to sell that I had told my dealer to liquidate it by shorting it in the futures market first thing in the morning and then keep converting the cash to futures as the volumes in the spot market are generally lower for the first few minutes of trade. I managed to sell my balance quantity at around ₹216 in the first few minutes of trade even as the stock went circuit down by 10%.

One of the unwritten rules of investing is to 'stop the losses' which is different from using a 'stop loss'. Personally, I was more relieved after I cut my position than I was before it. Sometimes taking losses helps us retain the large profits that we will make elsewhere. This is because investing is not just about 'Return on Capital' but also about 'Return of Capital'. Even though I made decent money in Titan the mind remained fixated on the pain of not selling at the highest recorded price. *An investor should not get perturbed by the loss of profits as taking losses both of capital and of profits forms an integral part of an investor's life. If an investor can do what is right, money will follow as easily as it left him. Contrary to this, if an investor suffers from the urge to recover losses the end result will be just an extension of the losing phase.*

It is always a better feeling to see a stock go down after an investor has sold it than to see it go up after he has bought it and the grief of selling Titan 30% from the top was being adequately compensated by seeing the stock go down 10% from my average selling price! However, Titan recovered the next day and inched up closer to its old levels of ₹260 at which point the RBI withdrew its restrictions on taking gold on lease but for me the story was over as it was a challenge staying invested in a company with so much of regulation around. The policy flipflop continued as the RBI reinstated restrictions on gold lease and the stock came crashing down to ₹220 again. As I hold concentrated positions each rupee of adverse movement in the stock that I sell gets me worked up on my mental arithmetic as I start visualising the notional losses

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that I should have no business thinking about in the first place. To save myself from this unnecessary headache one thing that I do after selling a long term holding is not to look at its price for the next few days. To facilitate this strategy, I remove it from the screen and if the stock forms a part of the ticker tape on TV I stop watching that channel also, as I don't want to see the price of a stock which I have completely offloaded. There is no point causing heart burns on a cause against which an investor has no remedy.

Its easier to fall in love after one has broken up and even though I was tracking Repco Home Finance and had a very small position I used all my Titan proceeds to aggressively load up into Repco Home Finance Ltd, a company providing low ticket home mortgage in the Tier II and Tier III towns and cities of India with years of uninterrupted growth ahead. Later, I met the Repco management at Chennai and bought more of the stock. Over the next six months Repco had moved up 70% from my buy price and more than adequately compensated me for the breakdown in the Titan story. Repco along with Gruh is a twenty year story unless the management does something totally different from what it is doing now.

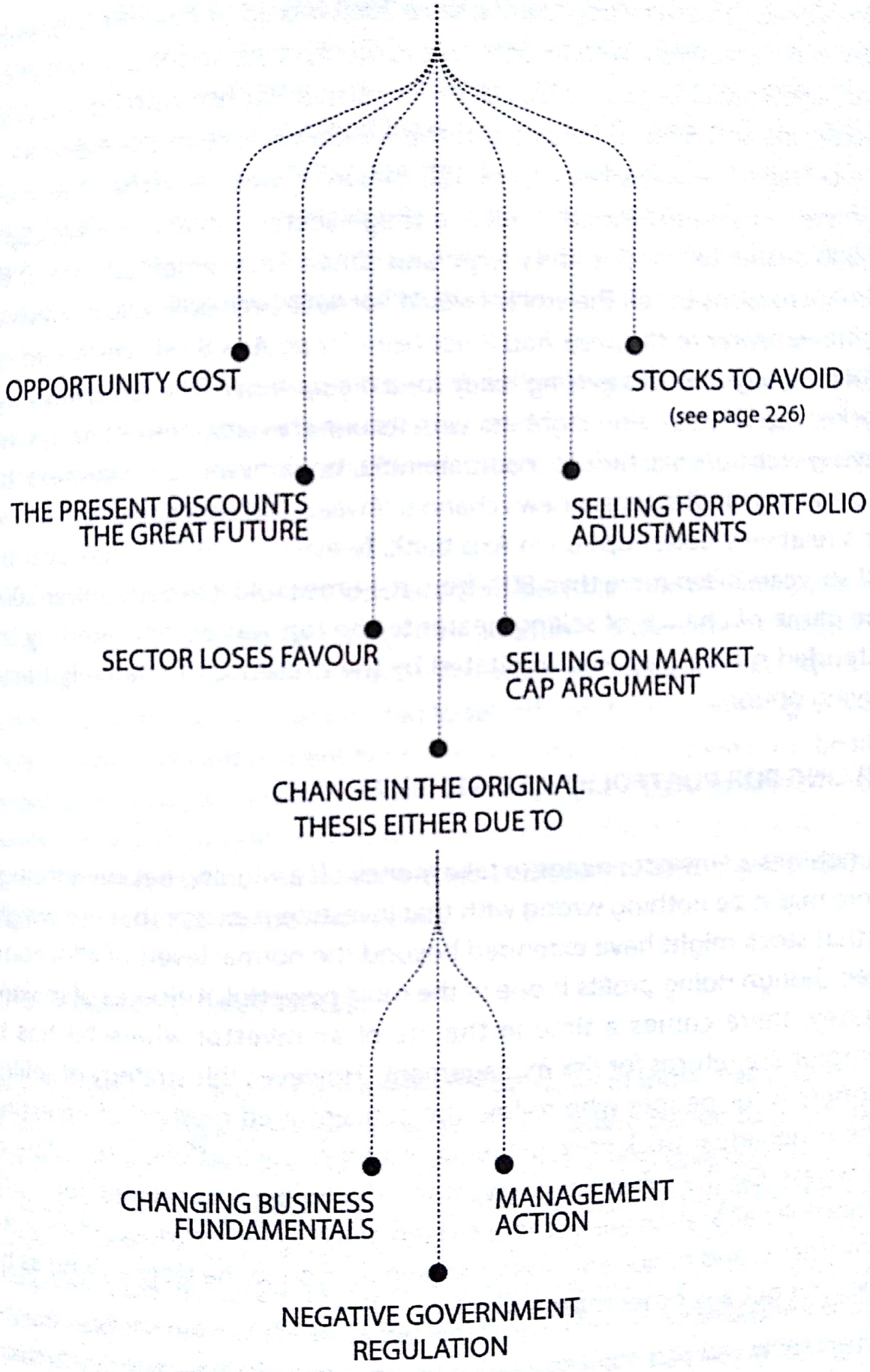
SELLING ON MARKET CAP ARGUMENT:

The market cap is also a robust indicator of whether the stock is over or under valued. *Sometimes a stock with a low P/E ratio might be expensive just because its market cap has ballooned to unsustainable levels whereas in other cases a stock might be cheap even with a high P/E ratio, if its market cap is low when compared to the scale of opportunity that the sector presents.*

When the market cap of the leader gets closer to the entire market size of the sector it sends a definite sign of overvaluation unless there is just one company that constitutes a major part of the sector. At nearer to ₹200,000 crores Bharti Airtel made little sense as the company's market cap crossed the total potential sector revenues; similarly the market cap of Infosys in the technology bubble of 2000 at around ₹100,000 crore exceeded the revenues of the entire IT sector. In 2008, L&T had an order book running at a couple of percentages of our GDP and analysts wanted L&T to grow at 25% which meant that the total order book of L&T could exceed the Indian GDP in twenty five years which by itself seemed a bizarre challenge to overcome!

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WHEN TO SELL?



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MY OWN STORY - SELLING TELEVISION EIGHTEEN:

Television Eighteen, a stock I owned since 2003 was up 14 times till September 2007 and collectively with its other group companies sported a market cap of around ₹5,000 crores. At that time, its partner Viacom with international operations and 50% of interests in the Indian venture of the Network 18 group traded at a market cap of $20 billion. It was clear that Television Eighteen was an extended stock in a tough sector and at a market cap of ₹5,000 crores seemed to defy logic and sense. This remained one of the primary reasons to sell the stock. *I would not have been able to exit Television Eighteen nearer to the peak had it not been for an Axis Bank which had just diluted equity and was getting ready for a big up-move.* The relatively large market cap of Television Eighteen with its unnecessary internet forays into buying websites like Indiwo, compareindia, bookmyshow, cricketnext, the loss making hindi business news channel 'Awaaz' forced me to exit the stock for a relatively better option in Axis bank. Television Eighteen, has over the last six years fallen more than 90% from the time I sold it in September 2007. The game of chance of selling nearer to the top was accentuated by the extended market cap and facilitated by the presence of relatively better buying options.

SELLING FOR PORTFOLIO ADJUSTMENT:

Sometimes an investor needs to take money off a winning bet even though there might be nothing wrong with that investment except that the weight of that stock might have extended beyond the normal levels of allocation. Even though riding profits is one of the most powerful attributes of making money, there comes a time in the life of an investor where he has to compromise returns for risk management. However, this strategy of selling winners is for people who follow the concentrated method of investing where individual stock price movements moves the portfolio into a state of skewness. On the other hand, investors who follow a diversified approach to portfolio allocation are not affected too much by the individual stock price movements and hence an investor should hold on to the stock as long as he does not get any other reason to sell it.

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This strategy of selling a part of the stock in order to reduce risk is in theory a confusing signal. How can an investor be bearish on a stock (portion sold out) and bullish on the same stock (portion retained)? The real reason why investors sell a part of a stock is because they are confused about the same and if confusion is causing an investor to sell a part of his holding then should he not sell the complete position because being in doubt it makes sense to stay out. An interesting analogy on this is, if an investor buys a house and the price of the house moves up, does he sell his verandah and the drawing room to lower the cost of bedroom, bathroom and the kitchen? If he doesn't, then why look at stocks from a different perspective.

Personally for me, it has always been a sell all or keep all strategy except for the minor tweaking that I keep doing to stocks. Hence, if I get bearish on a stock I sell all of it lock, stock and barrel instead of selling a little to lower the cost of the existing holding.

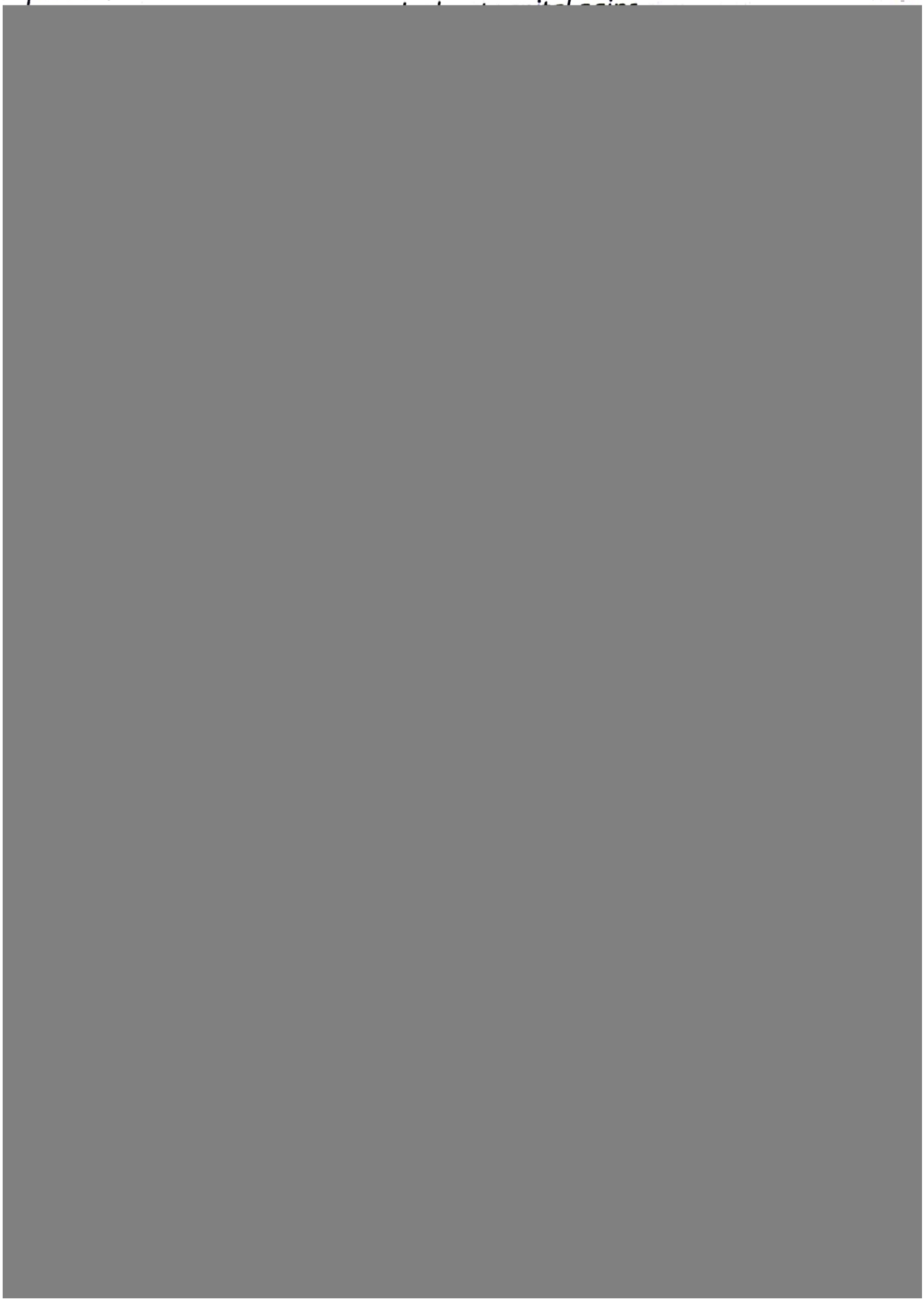
Sometimes an investor with a concentrated portfolio finds it difficult to sell a stock just because he cannot get an adequate replacement for it. The ownership bias of owning the stock will restrain most investors in letting go of it but after an investor has decided to sell off the stock he would generally have a better mindset of identifying a new winner than he would, if he had no plans of selling it. Generally, I have multiple stocks ready to take over the position if any of my leading bets were to be sold off and if I cannot find one, I try and allocate the capital to the tried and tested HDFC Bank and then reallocate it back to the others - slowly.

NOT SELLING TO SAVE TAXES:

As long term capital gains are exempt from taxes in India many investors refrain from selling a stock just to extend the holding period to more than twelve months. This strategy of not selling a stock just to save taxes has been the cause of many a profitable positions moving into the negative territory. *It is better to sell a stock and pay taxes rather than retain it and risk giving back the gains to the market but as payment of taxes on short term capital gains is certain and the price of the stock moving down after being sold is uncertain, most young and inexperienced investors go with an uncertain loss of risking the*

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price to fall back rather than pay the tax which is definite and certain. In the process, these investors cause more harm than if they would have just sold the



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the stock did nothing even while its competitor HDFC Bank was on a full swing expansion strategy over the past five years.

If a lending agency suffers from recovery issues and its stock is already trading at below book value then the worst has probably been factored in the price. In most cases, the first signal to sell will come with the deteriorating economics of the sector to which money has been lent, with a rising NPA profile and a confirmation to these two events will come from a slowing business both in loan as well as network expansion.

With banks it isn't such a bad idea to switch from a HDFC Bank into the second tier private banks like Indusind and Axis when the industry is passing through pain and then back to HDFC Bank when the environment gets better. *This is because the weaker companies generally outperform the stronger ones on the way up while the stronger ones do better than the weaker ones - on the way down.* When the economy improves banks with vulnerable loan book show maximum price action but the switch from the high quality banks to the moderately managed ones should happen only on the definite signs of a turnaround, a prelude to which would be the first reduction in interest rates.

WHEN NOT TO SELL?

A key reason for selling a stock is over valuation. If the company in question is a small cap then an investor should reconsider his decision to sell on valuations alone. Working from a small base, a small cap enjoys more freedom from the market because their growth is generally assumed to last longer and because of this, the P/E ratio also expands and then waits for earnings to catch up. It happened to HDFC Bank during 2000 to 2003 when the price went nowhere as the stock waited for earnings to catch up and it is happening to Jubilant Foodworks now as prices are going nowhere as they wait for earnings to move up.

Though there are no definite foolproof rules to selling, it is important to understand that a stock which has got expensive because of prices moving ahead of fundamentals is less likely to suffer a deep price damage when compared to a

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stock whose revenues and profits are slated to enter a permanent period of slowdown in comparison to the growth generated in the immediate past. Infosys which had been growing at 100% CAGR shocked the markets when it suddenly came out with a lower growth guidance in 2001 and it took 6 years to recapture its old highs while ACC could not match its 1992 profits of ₹136 crores till 1995 even as the stock price took 13 years to take out its 1992 high of ₹399.

The valuation destruction has to be initiated by damage to the fundamental set up of the business. After 2008, all infrastructure companies slowed down from their normalised 30% to 40% growth and the markets reacted with a severe thumbs down resulting in a near 80% cut in prices of almost all the leading stocks of the 2003 to 2008 bull market rally.

The bottom-line is that as long as the company does nothing wrong on the fundamental side, selling a stock early on valuation concerns could be detrimental. *Generally, the high P/E of a stock stays high far longer then analysts can predict and descends lower far more quickly then they fear. This is because stocks can remain over and undervalued for longer periods of time.* The primary catalyst of change in the valuation of a stock is the growth rate both with respect to P/E expansion and P/E contraction. So selling stocks just because they are expensive and have got ahead of current earnings should be avoided by long term investors especially if the company is small with respect to the total size of opportunity and the business in question is poised for years of above average growth.

STOCKS TO HOLD 'ALMOST' FOREVER:

There are a certain category of stable long term compounders that one has to be reluctant before selling. These companies like Asian Paints, Nestle, GSK Consumer, HDFC Bank keep growing year on year with a predictable earnings stream. In some years, the rise in price will exceed the increase in earnings and the stock will tend to stay at a certain level to wait for earnings to catch up whereas in other years the rise in price will be less than the increase in earnings giving investors an opportunity to make more than the stated 20%. Asian Paints was at ₹280 (adjusted for stock splits) in January 2012 where it

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had not moved for around a year and by March 2013 the stock was hitting ₹500. Nothing changed with the company, just that the stock stayed sideways because the company's earnings per share remained unchanged for the financial year 2011 at ₹8.08 compared to ₹8.07 for the preceding year even though revenues grew by 25%. The flat earnings because of a rise in price of crude oil between 2010 and 2011 resulted in a flat stock price as there was no earnings power to take the stock price up. Interestingly in the year 2012, EPS rose 25% to ₹9.99 and was up again to ₹10.94 for financial year 2013. The market responded by taking the stock to ₹500 much ahead of current earnings in almost a straight line as the stock now waits at an enhanced valuation for earnings to catch up.

With most of these secular large cap compounding stories investors would do well to hold and stay put. There should be no reason to take the money off the table as these growth machines continue to compound year on year. Taking profits off a stock just because it has gone up or selling a slightly overvalued, stable long term compounding machine unless an investor has found another attractive investment opportunity puts self imposed restrictions on an investor's ability to make consistent long term gains.

SELLING A STOCK TO BUY IT BACK AGAIN:

Many new investors want to sell a stock just to get back in after it drops a little from their selling price. This lure of buying a stock back at a lower price looks like a free lunch, a concept that looks free only till the trade is executed. *In most cases, selling a stock to buy it back later on a slight dip isn't necessarily the optimum way to get rich but is surely a nice way to get rid of stocks that will make an investor rich.* An investor might succeed at this strategy for a couple of times but ultimately this process of selling a stock to buy it back on a small correction will make him miss a long term story for an uncertain short term gain. Let us assume that an investor sells a stock at ₹1,000 and then sees it drift down to ₹950, at that moment he would be looking to buy it lower as having being proved right in his original thesis he would try to make the maximum out of it. Now if the stock falls lower to ₹920 then the investor's subconscious mind will look at an even lower price to buy but then if the stock rises back to ₹945 than this price of ₹920 will remain anchored in his mind as he would now look to buy it at ₹920 but if in the process the stock goes back to ₹1,020 then buying an equal quantity of the stock again will seem as difficult as lifting the Eiffel Tower with one hand!

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An investor who is convinced of a long term story will not try and make these small time gains but someone who isn't convinced will try to profit from every short term stock price movement.

In 2003, I had a very small position in Mastek, a software company that was doing a project on London's inter city traffic management systems. As this project neared completion, the company suddenly declared that growth would be under challenge as it had failed to get new orders to replace the old ones. The stock which had doubled for me was trading at above ₹500 and opened around 100 points lower the next day and I managed to sell all my shares at around ₹390, the stock fell some more and was at ₹350 in a few more minutes. These forty rupees seemed like a gift from heaven and I quickly bought back all that I had sold. The stock ended the day to close at ₹230.

If the story has played out then it makes sense to sell the stock and look at new ideas rather than hope for something good to happen to the company whose stock an investor holds.

One recurring theme of my investment style is that except for a HDFC Bank I have seldom looked back to buy a stock after having sold it. So whether it was Pantaloon Retail, Trent, Television Eighteen, Axis Bank, Volatamp, Thermax, Zydus Wellness, or any other stock I have mostly refrained from getting back in either at a lower price or even otherwise. The reason for my reluctance to buy back a stock that I have earlier sold is that almost all these stocks were bull market companies or a typical case of undervaluation play and once a bull market stock has been sold and the party ended an investor will do well not to get back in.

BROKERAGE REPORTS ARE BIASED ON 'BUYS':

Brokerages and analysts are more prone to coming out with 'Buy' reports than with the 'Sell' calls. This is because if a broker recommends a 'Buy' on a stock then he gets all his clients to be a potential buyer on the stock with the cash that they hold whereas if he comes out with a 'Sell' call then his potential clients reduce to only those who hold the stock or are willing to go short on the same in the derivatives market. Also some potential clients can take cognisance of the 'Buy' report by selling other stocks which makes 'Buy' reports more revenue accretive from the brokerage point of view. In an

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inflationary world, stocks are more likely to move upwards than come down which makes it easier for research houses to recommend more 'Buys' than 'Sells'.

MY OWN STORY - SELLING PANTALOON RETAIL:

When a stock is making new extended highs the news flow surrounding the same also increases. Consequently the list of bulk deals will reflect names of various investors and funds as being aggressive buyers in a stock. This is not something extraordinary because if a stock is trading there will always be someone buying and selling it. However, an individual investor gets clouded by the names of all the big boys as reflected in the papers. I had made my basic capital buying and holding shares in Pantaloon Retail, a stock that went up to a high of ₹875 from my buy price of ₹7. *However, after the stock crossed ₹500 there were news of different funds buying the stock and each time a news report came about a fund buying the stock, the existing investors were getting more convinced about the investment based on the entry of new investors and not because of what the investment was going to do for them.* There were also news reports of the company selling its different businesses through spinoffs and the market had seen the amount of wealth that the Reliance de-merger had created and I was myself riding on the recent gains from the Television Eighteen spinoff, hence it seemed that the market cap would be held in the backdrop of the potential spinoffs even though valuations had reached the moon. *However, the reality of the investment world is that an investment might be influenced by an investor for a day, week or even a month but ultimately the stock will be influenced only by the underlying economic character of the business that the investment represents.* This started to happen as the stock finally fell down under its own weight and dropped to ₹500 then ₹400 and finally broke ₹300 at which point I decided to throw in the towel and sell. I have never considered myself unlucky for not having sold at ₹875 because had I been so focused on valuations I would have folded it up earlier at a lesser price that I had ultimately disposed the stock at. Pantaloon was a bull market leader and the time to sell it was after the bull market had peaked in 2008 by which time the stock had already fallen to less than ₹500. In any case, as all stocks were falling any stock that I would have bought after having sold Pantaloon would have met the same fate.

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Pantaloon's growth story was also slowing, a fact that I failed to recognise. The slowdown was evident in the same store sales which were growing at more or less the inflation rate. The company's forays into insurance, asset management and other unrelated ventures like incubating new firms were also not making any money. Big Bazaar was their hyper market model that was a hit with the crowds but the new store openings cannibalised the existing ones as customers found it easier to buy from the store nearer to their home than drive those extra miles. From one or two Big Bazaars, large cities in India had seven to ten Big Bazaars. The problem was that if Pantaloon did not open these stores then Reliance Retail or Aditya Birla's 'MORE' or RPG's 'SPENCER' would have opened it, so Pantaloon was forced to open new stores even as these new stores cannibalised the existing ones. A similar challenge was posed for Television Eighteen which had to open a Hindi business news channel 'Awaaz' even while knowing that the same would not be making money because had it not opened this hindi channel its competitors would have done so. Sometimes, market share and market size acts as the death knell for many companies but in this case it was a case of working in a sector where the absence of entry barriers ensured that no one could make superior profits for longer periods of time.

Estimating when a high growth company will hit a road block is both an act of skill and chance. Sometimes, a company that was growing too fast starts to acquire other companies in the same business which is the first sign of a growth slowdown. Analysts refer to this move as consolidation which effectively means that the weaker players are giving in to the stronger ones. However, a consolidation also signifies that the industry is also seeing the first signs of stress. In good times, all players do well irrespective of whether they are weak or strong but its the economic slowdown that separates the wheat from the chaff.

Overall, the question of when to sell is the most difficult one to answer. The shortest answer to this is for a high quality company in a high quality business even if the investor misses to pull the trigger to sell he will not do that badly. On the other hand, a low quality company in a low quality sector demands immediate attention to the problem of when to sell as a few months of extended holding can destroy several years of hard work.

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Chapter 32

BASIC ECONOMY STOCKS, DIVERSIFIED BUSINESSES AND SPINOFFS

It makes sense to be in certainty when uncertainty does not make a great deal more.

Many investors are attracted to low P/E stocks with the belief that a cheap stock provides better opportunities for stock price appreciation. These bargain hunters do not realise that more money can sometimes be made by buying high P/E stocks rather than running exclusively after the low P/E ones as the P/E ratio of a stock also indicates the level of business quality that the stock represents. Generally, companies that are related to the basic economy trade at a low P/E ratio as these sectors suffer from a severe lack of entry barrier with inconsistencies in growth. It has been observed that except in case of a roaring bull phase the markets are generally right in valuing a business with lack of entry barriers at a lower P/E because a business without entry barrier is challenged for predictable growth - almost all the time. In this chapter we discuss the various sectors of the Indian market whose stocks generally trade at a low P/E ratio and the reasons for the same.

AGRICULTURE:

Agriculture in India is a tough business as it is dependent both on the monsoon as well as the government policy. *The Indian farmer also suffers from the paradox of plenty as he gets a lower realisation in years of a bumper harvest and a higher realisation in the years of a lower harvest thus ensuring that a farmer's income always remains regulated.* However, there are ways to play the Indian agriculture growth story indirectly by buying stocks of the seed producers, the two wheeler makers, the tractor manufacturers or from

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agencies that undertake lending in specific rural and semi urban areas. A few names that come to mind are Rallis India, Hero MotoCorp, Mahindra & Mahindra, Gruh Finance and Repco Home Finance all of which have a stable rural India presence. Even though fertilisers are an essential agriculture related input, they remain regulated in India through government policies and suffer from lack of pricing power and therefore remains insulated from investor fancy.

Seeds are different from fertilisers. While the latter is regulated and has little pricing power most of the seed companies are allowed to work with relatively more freedom making them a better investment option over a fertiliser company. Some seed companies like Rallis and Kaveri Seeds do enjoy pricing power because of patent protection laws and are a better way to play the agriculture theme. However, these companies work with the potential threat of their MNC counterparts coming to India with their full bouquet of products once the patent laws in India are brought up to international standards. The single product seed company also suffers from the vagaries of the underlying product because if the price of the produce falls on a bumper harvest then farmers get to make little and opt for the alternative crop in the following year which increases the risk of these single product seed companies from generating a long term secular growth.

Tea is purely a commodity business and unless a company becomes a complete branding and marketing company and goes in for value added products like green and herbal tea it would suffer from the same problems that affect a cyclical commodity company. No wonder then that returns from tea companies have over the past several years been weak to moderate.

Businesses connected with the environment find it hard to get a higher valuation due to the overall concern on environment protection hence, one should think twice before buying the plywood manufacturers. Then there are sectors like paper and basic chemicals which keep struggling for a better valuation because these businesses do not have a very significant history of having made too much wealth for their investors over the long term.

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Textile and Sugar are sectors that suffer from cut throat competition, government regulation and cyclical earning swings and unless a textile manufacturer becomes a branded garment manufacturer it continues to be valued at a low P/E ratio

AUTOS:

While passenger cars and more importantly two wheelers are steady growth stocks, commercial vehicles do well with economic recovery only. As India reaches a higher disposable income the demand for passenger vehicles are bound to show an increase but with so many car manufacturers around the two wheeler market is better placed with just two dominant players and even in that Bajaj Auto with a 35% export revenue is a natural hedge against adverse dollar movements. The leading two wheeler stocks have multiple years of steady compounding growth ahead of them. They work with negative working capital, generate free cash flows with a high RoE and distribute a higher dividend to their shareholders and to a very large extent have the attributes of an FMCG company.

AUTO COMPONENT SUPPLIERS:

The business dynamics for companies that do the outsourcing work for a larger industry player will depend on the nature of its buyer's business. For example, while auto component suppliers might generally appear to be engaged in a steady business their momentum of growth is largely dependent on the fortunes of the large auto companies.

Auto component suppliers like the battery and the tyre manufacturers get direct repeat orders from customers and do better than companies whose products do not find repeat customers too often. The number of people who get their car air-conditioners and the gear box changed every few years isn't too much when compared to people who get their tyres and batteries replaced every four to five years.

A company which predominantly supplies to customers with cyclical earnings also experiences cyclical swings in its own earnings trajectory. But there are

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some consumables in the auto ancillary space which do not have cyclical earnings. Moreover, if an investor wants to buy the auto component suppliers he should move away from stocks that have a single dominant buyer, so in spite of high valuations, a Bosch which manufactures fuel filters or an Amara Raja, the manufacturer of the Amaron brand of car batteries is always a better option than a Munjal Shova or a Shivam Auto.

Even while buying a Amara Raja an investor should check out the percentage of replacement sales. This is because the bargaining power lies with the buyer in case of their direct manufacturer supplies as the price which a battery manufacturer would quote for selling 200,000 batteries would be lower than that of the replacement market where the customer buys just one battery which shifts the bargaining power back to the supplier.

If the auto industry did well in a certain period of time then the battery makers do well after three to four years which is the replacement cycle for an average battery. Therefore, if 2009 was a booming year for auto companies 2013 could well be good for the battery manufacturers as it would see an increase in replacement demand for batteries from vehicles sold four years ago.

Investors can use the same strategy for analysing the tyre manufacturers and other component suppliers used to service the auto industry. MRF the tyre manufacturer has moved up around 23 times or at a 35% CAGR since 2003, even while revenues and earnings have compounded annually at around 20% only. At the current price of more than ₹19,200 MRF trades at a P/E of less than 12 and at a market cap of more than ₹8,200 crores looks set to reward its shareholders again over the next decade though not in the same scale as it has done for the previous ten years. The company has not seen any significant re-rerating in spite of its steady performance because it generates a RoE of only 20% and also does not have a good payout structure as the dividend yield is just 0.1% of the current price. The fact that the company does not declare a bonus is inconsequential as there are many high P/E stocks which do not declare frequent bonuses so the primary reason for the P/E ratio not moving up is the moderate RoE and the abysmal yield.

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Motherson Sumi is another auto component manufacturer that has grown its top line at around 29% CAGR for the last ten years. In the same period profits have grown at a CAGR of 32% while its stock price is up 90 times, having grown at an annualised rate of 53%. The rise in stock price has been facilitated by a six times expansion in the P/E ratio from around 5 times in 2003 to over 30 times now. Motherson Sumi has a smaller yield at around 1% but its RoE at above 30% helped it undergo a P/E expansion, unlike MRF whose moderate growth and RoE was not enough to act as a catalyst for a significant expansion in its valuation multiple.

CEMENT:

Cement as a business grows at around one and a half times the GDP. Though it is difficult to generate long term wealth out of cement companies, Shree Cement which is up 100 times since 2003 remains an exception to this rule. On the valuation front cement companies are normally valued at an Enterprise Value (EV) to capacity. Frontline cement stocks are generally valued at around $100 to $110 for each ton whereas the smaller ones go at $60 to $70 per ton. The valuation is however, influenced by the size of the plant, the geographical location and the management pedigree. This means that a national level company with a capacity of 25 million tons will on an EV to EBIDTA of $100 be valued at $2.5 billion dollars. If the company has some debt then an investor needs to remove the debt component from this valuation of $2.5 billion to get a broad sense of the market cap. In other words, one should evaluate a cement company on the basis of the overall enterprise value rather than by looking exclusively at the P/E ratio and the RoE.

ELECTRONICS:

Electronics is an industry where what is new today is used tomorrow like yesterday's newspaper. Unless one has bought an Apple or a Samsung the electronics industry suffers from serious and quick obsolescence and hence the market always remain suspicious of their long term survival and refuses to give it a higher P/E.

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HOTEL STOCKS:

A hotel enjoys very limited scope of volume growth because once a hotel has been put up further growth can come only by raising prices which in any case is a limited option for a business because the moment people see demand they set up new hotels. A couple of decades back there were just a couple of hotel chains around which have now expanded to about more than a dozen now. With high real estate prices, hotel as a business will underperform the general market and the best way to play hotels is when they are coming out of a slowdown. Multiplexes, holiday home sharing and gyms all have more or less, a similar business model.

INFRASTRUCTURE, CAPITAL GOODS AND REAL ESTATE STOCKS:

Infrastructure and construction stocks had a big bull run between 2003 to 2008 which confused a lot of investors to mistake this cyclical sector for a secular growth business not realising that any business which is capital intensive, without barriers to entry and whose product and service cannot be differentiated from that of its competitor will find it hard to grow at a steady rate over longer periods of time.

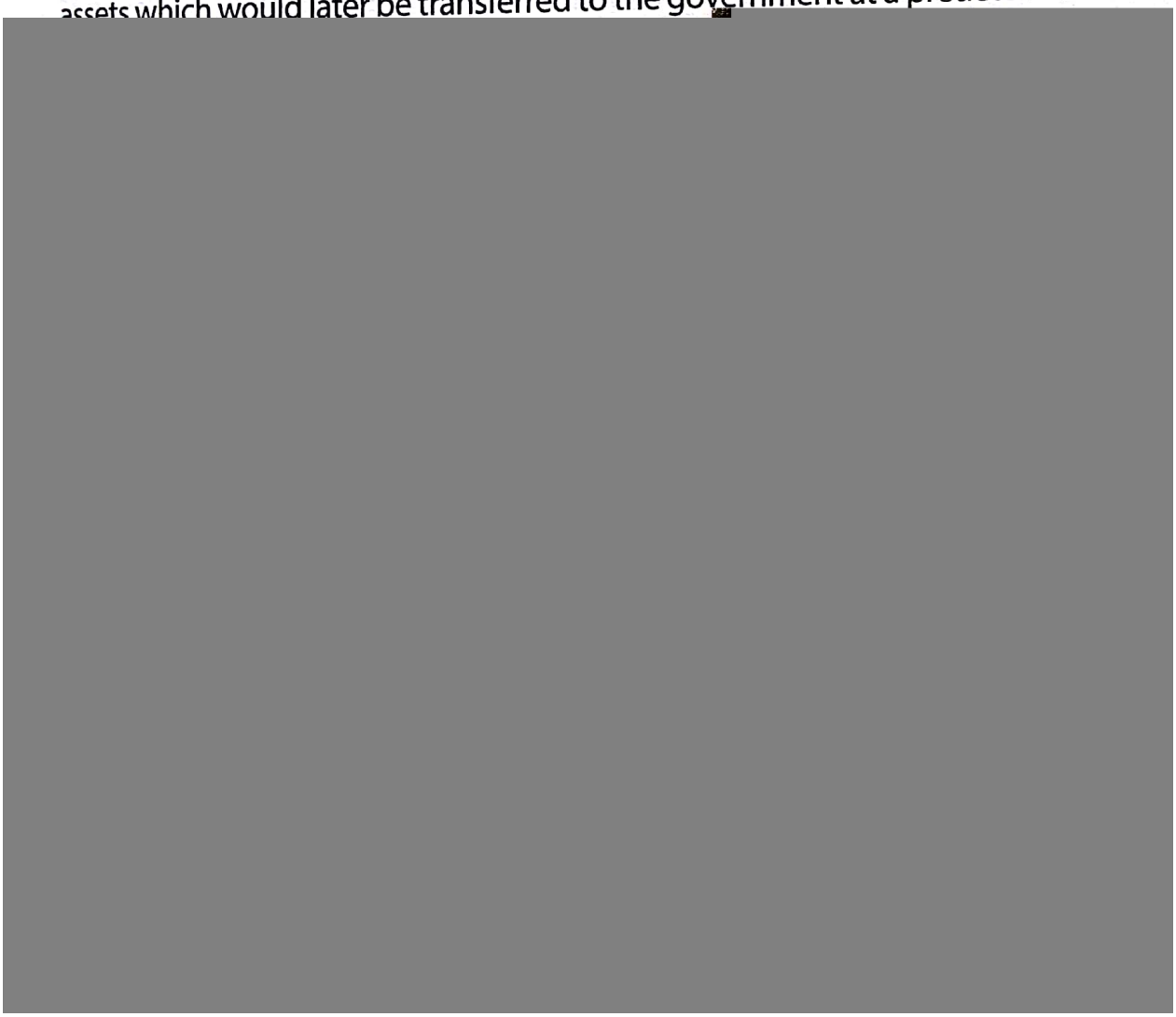
Most of the construction and infrastructure stocks grew at above average rates in the previous bull run because the abundant liquidity facilitated frequent and easy dilution of equity and debt. Most infrastructure and capital goods companies do well when there is an overall economic boom. They react to economic recovery with a lag effect that is, these companies get new orders only when their buyers are convinced that the economic recovery is in place and the existing capacity has been fully utilised. The main aspect to look for while evaluating these stocks is the order book, as the stock price mirrors the order book momentum rather than the actual earnings growth. The stock of such companies could keep falling even while reporting higher earnings growth just because the effect of a slowing order book spills over to the earnings with a lag as it happened in the case of BHEL after 2008, where the stock started to fall in the backdrop of a lukewarm order book even while earnings continued to rise at a steady pace. Additionally, in a down cycle the order book should not be given much importance as in such

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cases the old orders gets cancelled or postponed while the new ones dry up as no one wants to initiate capital spending when the chips are down.

Due to wide earning swings, looking at the P/E for these infrastructure and capital good stocks is not the best of strategies, so instead of valuations one should take a broad macro call on whether the economy will improve or deteriorate from the time an investor contemplates buying these stocks to the time he thinks of holding it.

When these construction companies came on the scene in 2003, they were service oriented companies which employed little capital to generate a high RoE. Subsequently there has been a change in business character from 2003, so while they were pure service oriented companies with little capital expenditure and not too much competition, over the years these companies transformed themselves to get more into the build operate transfer (BOT) projects which meant that they had to put up capital to create infrastructure assets which would later be transferred to the government at a predetermined



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companies also suffer from non-linkages of raw material like coal, making their business unfit for investment with a long term view.

If an investor wants to play the power sector then he should try and bet on the power equipment manufacturers like ABB, BHEL or Siemens which work with little operating and pricing restrictions instead of the pure power producers like CESC and Tata Power.

Renewal energy is a business which is dependent on the price of crude oil and comes under investor fancy only when crude oil becomes expensive. Generally, investors hesitate to give a higher P/E to these type of companies as they lack a serious long term business plan. The two prominent companies in this segment are Praj Industries and Suzlon and while one has struggled to deliver the other struggles to survive.

REAL ESTATE:

The fortunes of the real estate sector is also tied to that of the general economy. Most real estate companies made money because of the land bank that they were sitting on. Once the existing land bank was valued to the current market price these stocks did not have anything more to show and being leveraged entities they fell down, by the wayside. As this sector is famous for underhand dealings, an investor should avoid these stocks and focus on the pure service providers or companies that don't carry land on their balance sheet like a Godrej Properties or the home mortgage financiers that have years of growth ahead of them.

DIVERSIFIED COMPANY WITH VARIOUS OPERATING BUSINESSES:

A challenge that an investor faces while valuing a company with various subsidiaries is to forecast the kind of P/E multiple which the company would trade at. Let's look at three companies in this context. Sundaram Finance, a strong NBFC player from South India which has interests in commercial vehicle lending, insurance, asset management and housing finance, Tata Global Beverages with interests in tea, holdings in Tata Coffee, and a valuable water resource subsidiary in Mount Everest Mineral Water and the recently

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started coffee retailing venture as an equal partner with Starbucks and finally Bajaj Electrical which has interests both in a robust consumer division and a bleeding infrastructure business.

In the case of Sundaram Finance, the steady commercial vehicle finance division grows at around 18% to 20% because the company caters only to the high quality borrowers and hence growing business without diluting the quality of its borrowers is not possible. The insurance and the asset management businesses do not grow at very high rates whereas its housing finance joint venture with BNP Paribas grows at around 35% to 40%. But when it comes to putting a P/E ratio, the market keeps it within a range of 10 to 12 because in spite of the rapid growth, the housing finance business contributes just 15% to the overall profits whereas the majority of earnings are made up by the other businesses that grow at a significantly lower rate making it difficult to break away from the traditional valuation matrix.

The same argument holds good for Tata Global where despite the super fast roll out of the Starbucks coffee chain the overall revenue and profitability remains unaffected as the weight of the coffee retailing business at less than 10% of overall sales is very small and hence the company continues to be valued on the prospects of its traditional businesses.

In case of Bajaj Electricals, the cash generated by the fast growing consumer division is used up in making good the requirements of the infrastructure business. Therefore, in spite of the profitability of the consumer business the market refuses to give it a reasonable valuation because the fear is that no matter how much money it makes it will always find ways to consume it through its infrastructure ventures. The management has however clarified that its infrastructure business is set to break even but the market will wait to see that before it acts a bit leniently for its consumer division. If an equity share has to be valued on the basis of its discounted cash flow, the cash guzzling infrastructure division restricts the company in generating free cash flow and hence accords it a lower P/E.

I bought Larsen & Toubro in 1999, on the same theory. The small infotech division was doing well and I thought that buying L&T was a better idea than

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looking at the expensive IT Service plays, the result was that Larsen refused to move for months whereas the IT leaders continued to make new highs. There was no reason for the market to rerate the stock as the percentage of sale originating from the software business was not even 10% of the overall revenue.

Alternatively, Wipro in the 1990's was a company with multiple activities but as a majority of its revenues originated from the fast growing software business the stock continued to enjoy above average P/E ratios.

PLAYING FOR THE SPINOFFS:

The traditional Indian businesses like Raymonds, Century, Grasim and Aditya Birla Nuvo (earlier Indian Rayon) were all diversified conglomerates in different business verticals like cement, steel, paper and textiles. This wide diversification was followed because under the license raj it was difficult to expand capacity without government approval and secondly as most of these businesses were cyclicals *the strategy of having multiple businesses in a single company worked like a risk control measure as these companies found it easier to handle a downturn in one sector with a boom in another.*

As the economy liberalised and investors got used to the idea of focussed companies, specialisation became the buzzword and companies restructured operations to spin off unrelated businesses. Generally, a company with a single business gets a better valuation when compared to companies with multiple unrelated businesses. This could be because an investor who is interested in the branded garments business of Raymond might not buy the stock because of its steel or cement division where he might be having a negative view. Raymond has since become a focused business just that the wait for its management to become focused is still on.

Some companies also operate small profitable subsidiaries, such companies are able to generate significant return for their shareholders just by spinning off these subsidiaries. This phenomenon was initially discovered when Reliance Industries spun off its various businesses when the two brothers separated after the death of Dhirubhai Ambani.

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Subsequently, there was a smaller spinoff in the Television Eighteen group where I had the chance to participate quite aggressively. The spinoff saw the shares of Television Eighteen move up 3 times in a few months of its spin off. In 2009, Cadila Healthcare also spun off its Sugarfree and Everyuth divisions and merged it with the newly acquired Carnation Nutra. The name of the company was later changed to Zydus Wellness, the shares of which rallied almost 10 times over the next three years.

When a company spins off a division, shareholders of the existing company get shares in the newly listed spinoff. The initial impulse of these shareholders is to sell the spinoff shares as they are considered free. Moreover, as shares can only be distributed in whole numbers fractional entitlements are bundled

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"You stagger buying when you are unsure if you are sure you back your conviction by converting cash to stocks."

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Chapter 33

ANALYSING COMPANIES WITH CASH ON BALANCE SHEET

Market pays for companies that put cash to work and not for the ones that put cash in the bank.

An astute investor's mind remains focused on ready made bargains and there is no bigger bargain than buying a company at a market cap which is less than cash* on its balance sheet. This theory of buying cash bargains assumes greater significance in bear markets than it does during bullish times as investors want to bet on surer things when times are bad and there is nothing more sure than real cash sitting on the balance sheet. An investor looking for a company with cash on balance sheet is generally looking for free hits, a strategy of buying a rupee worth of stock at fifty paisa, a concept also known as the cigar butt theory which is similar to looking for used cigars on the roadside where the previous user discarded it just when there were a few puffs left.

The cigar butt theory of investing was rendered popular after Benjamin Graham suggested that a company whose market cap was less than two-thirds of net current assets was a fair bargain. Graham argued further that investors ought to buy the stock at that valuation, if the net current assets are realisable and convertible into cash. However, the biggest drawback of this theory was it assumed that shareholders had the right to force the company into closure which with the advent of trade union activism and regulatory hurdles looks remote and unenforcible in today's environment.

*The term cash in this chapter includes the cash equivalents like investments and other non-operating realisable assets by whatever name called.

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WHY CASH GOES AT A DISCOUNT?

The argument why markets look at cash on balance sheet with suspicion is because cash among all assets is the most likely to get pilfered away. Companies that hold cash without any stated objective of deployment draw a debate on whether the cash is for real. This argument of treating cash with suspicion has increased after the Satyam Computer debacle where the company went bust showing cash on balance sheet of ₹5,361 crores out of which ₹5,040 crores was fictitious or non-existent.

The reason why cash goes at a discount is because it earns a lot less than what the operating assets do. *A bank takes deposits from its customers and then lends it out to businessmen for their operations so the operating return on capital by the business to remain viable, should be more than that paid by the bank to its depositors as in addition to the cost of borrowing, banks incur establishment expenses and also have to generate a decent return for their shareholders by recovering all these costs from their borrowers.* This is why markets do not like companies who hold (hoard) cash because held on its own, cash will be unable to match the returns from the operating side of the business. Assuming an interest income generation at 8% the compounded annual growth of cash would also be 8%, hence a simplistic P/E of the cash will work out to 8 times (growth) and at an EPS of ₹8 for every cash deposit of ₹100 the theoretical value of the cash would be ₹64 of the actual cash pile. If interest rates go up to 9% the value of cash increases to ₹81 (EPS of ₹9 x P/E of 9). No wonder, most cash surplus companies trade at discount to cash on balance sheet with their small operating businesses available for free.

CASH WITH A LOSS MAKING OPERATING BUSINESS:

Sometimes a company with cash on balance sheet is also saddled with a loss making operating business. In this case, the market does not discount the cash at full value but reduces it to the extent of losses that such an operating business might throw up, as these losses have to be funded from the cash pile lying at the disposal of the company. Trent in 2002, was one such company where the management had sold its Lakme business to HUL and was holding cash on balance sheet equivalent to ₹130 per share against a stock price of ₹100. The discount of the market cap to cash on balance sheet was because of the

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operating losses that 'Westside' its retailing venture was making. By 2003, Westside had recovered and was making profits at the operating level and the market put the stock on roller skates and by December 2003, the stock was trading close to ₹280. Though retail stocks had come in fancy and the overall bullish environment did help as the share price went up the pace of rise was accelerated by the reduced fears of cash being sucked in by the loss making retail division.

CASH WITHOUT A STATED OBJECTIVE GOES AT A HIGHER DISCOUNT:

The discount of the market cap to cash on balance sheet also remains when there is no stated management objective of deploying the cash. In such a scenario, the discount factors in the lack of control of cash for the minority investors. Additionally, fears about the cash being deployed in a new venture without considerations on profitability and RoE helps in retaining the discount.

WORKS BEST IN BEAR MARKETS:

Companies with cash on balance sheet reflect the optical margin of safety which generates incremental investor attention in bear markets as there is an overall flight for tangible assets. Instead of holding cash themselves, some investors find it comfortable buying companies with cash on balance sheet. *However, these companies tend to underperform when the market breaks back into bullish territory as in times of an overall recovery people flock back to growth stocks with operating businesses instead of defensive bets and as a bull market always starts on falling interest rates the idle cash earns a lot less than what they were when interest rates were high.*

ITS THE NET CASH THAT MATTERS:

One of the critical mistakes that investors make while analysing companies with cash on balance sheet is to consider the absolute level of investment and cash. Some companies because of their nature of business may be holding cash as retention money due to suppliers or security deposit from vendors for the unfinished work. In those cases, one has to reduce the cash to make these adjustments to arrive at the net cash available for distribution to shareholders.

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In case a company has a current asset which is greater than current liabilities and also reflects a positive cash balance then the cash balance will first have to be removed from the current assets to see if the residual current assets (without the cash) are enough to cover the current liabilities. If the residual current assets are falling short of meeting up to the current liabilities then that part of the cash on balance sheet which is equal to the shortfall will not be construed to be free because in that case the company will be left with a deficit to meet up to its current liabilities. So if the cash in hand is ₹100 and the current liabilities is in excess of current assets (without this cash of ₹100) by ₹30 than this company will be said to have a free cash on balance sheet of only ₹70 as otherwise the company will find it hard to relinquish its current liabilities. Similarly, the cash in hand will also have to be reduced by the long term debt and employee provisions like leave entitlements, gratuity etc that the company carries on its books.

The net cash so arrived will have to be divided by the total number of equity shares to arrive at a cash per share value. So while computing the P/E of the stock one can reduce the market price by this cash per share but to get a true discounting of the operating earnings of the business one will have to correspondingly reduce the company's earnings by the post tax interest income that this cash pile generates.

The cash on balance sheet of a company is therefore not the absolute cash or current investments lying on the balance sheet but is subject to the working capital whichever is lower adjusted for the long term liabilities and provisions of the company.

USING CASH FOR BUYOUTS:

However, before investing in companies with cash on balance sheet an investor has to be convinced whether the cash is for real and the management's intention of using this cash for the benefit of the minority shareholders. There are no foolproof methods to check this except that cash lying on the balance sheet year on year without a stated intention on deployment is not something that will keep the minority shareholders excited. However, most managements get around the issue by keeping an open ended acquisition plan in mind so any

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question as to the use of cash will be explained by the management's intention of making an acquisition whenever the opportunity arises. In general, companies are too loath to let go off the cash.

On the other hand, starting a new operating business is a time consuming process and is unlikely to yield quick results from the stock price point of view unless the market actually sees the concrete benefits of the new venture. Coming back to the example of Trent, the company held on to its cash for a very long time and finally bought over 76% of the books and music retailer 'Landmark' in August 2006 for ₹103.6 crore. The buyout valued Landmark at one time sales and seemed a strategic fit to Westside's private label business. The market greeted the buyout by sending Trent's shares into the upper circuit as the idle cash earning a bank rate of interest was suddenly being deployed into a fast growing operating business. The rally in Trent however fizzled out as the market saw no signs of an aggressive roll out of stores of the acquired entity while its peer Pantaloon Retail continued to expand at a scorching pace. During the period 2003 to 2006, Pantaloon was doubling revenues every year while Trent was growing at between 35% to 40% only. The gap kept widening and in some ways the 'Landmark' buyout was also a desperate measure to regain the advantage that Trent had lost out to Pantaloon.

Piramal Enterprises was another such company which became flush with cash after it sold out its pharmaceutical business to Abbott. The company with a very small operating business and a large cash pile was soon considered a bargain as the cash per share in excess of ₹500 was more than the market price with the operating business available for free. The company further declared its intention to use this cash for taking up minority stakes in other companies. The market started valuing Piramal as a close ended mutual fund scheme and put the stock under a 30% discount to cash. Slowly, the Piramal management deployed the cash into buying shares in Vodafone, setting up a new drug discovery business, venturing into informational analytics in the healthcare business, investing in real estate and financial services and venturing into the defence business. The stock after falling to ₹350 is now pretty much near the value of its investments.

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LIMITED GAINS:

While investing in companies with cash on balance sheet does protect the downside, the prospect of an immediate upside in such stocks is generally limited, unless there is a strong catalyst waiting to unlock the cash value for the minority shareholders. *While one cannot go wrong big time by investing in companies with cash on balance sheet one cannot go right by a great deal either.* Companies with a large pile of cash on balance sheet can create gains for their investors if they give out a one time hefty cash dividend or use the cash to scale up a new profitable fast growing operating business. Giving out a one time high cash dividend is an immediate re-rating trigger as it is RoE accretive. Personally, I don't like looking at cash bargains because I prefer playing for the big swings rather than bet on these cash bargains to come up to their fair value.

Cash on balance sheet companies generally find it difficult to outperform the markets over longer periods of time because they generate a low return on equity. A company holding free cash also indicates that it does not have any immediate avenue for business development and finally a cash on balance sheet stock can rise only to the extent of undervaluation which in any case is restricted to between 30% to 40% of the current market price with a timeline which remains undefined. This means that if the valuation expansion does not happen quickly then the investor incurs an opportunity loss as there are several 20% bets available in the market at any point of time.

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ANALYSING BANKS AND NON BANKING FINANCE COMPANIES (NBFCS)

Banking is all about losing money as long as you can make reasonably more than what you lose.

In a country like India where large sections of the population is underbanked the growth in the financial services space should outpace most of the other sectors over the next several years. Data suggests that about 700 million Indians do not have a bank account which creates a huge opportunity for the entire banking space over the next two decades. Moreover, the penetration of mortgages and consumer finance continues to be very low when compared to not just the developed economies but even the other emerging economies.

Banking as a sector grows very closely with the overall level of economic expansion. Empirical data suggests that if real GDP grows at 6% the growth in the financial services space should be three times that rate at 18%. A sector that grows at 18% is bound to generate long term wealth creating opportunities. However, unlike the other sectors the banking space does not generate quick multibaggers because a lending business that grows too fast leaves behind a trail of bad loans. This when viewed in the context of the leveraged business model threatens the long term survival of the very business itself.

FOCUS ON RISK MANAGEMENT:

Investors in financial stocks should focus on banks that manage their risks better rather than the ones which remain focused on only growing their

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business through loan book and network expansion. Two banks starting at the same time might have entirely different expansion strategies but the bank which focuses more on risk management will be able to survive for a longer period of time. As banks borrow up to 8 to 10 times their net worth even small defaults make them vulnerable to insolvency risks. A bank with a net worth of ₹125; could borrow another ₹875 to create a loan portfolio of ₹1,000 which even with a 5% delinquency or ₹50 has the power to wipe out 40% (50/125x100) of its net worth.

While it is not important to buy the largest bank in the country it is essential to focus on banks that have reached some sort of critical mass and size as a smaller bank is more likely to get into trouble than a mid sized bank. Banks that have filed for liquidation in India have been the very small cooperative banks like the Bank of Karad and the Metropolitan Co-operative Bank during the Harshad Mehta scam or the Madhavpura Mercantile Bank during the Ketan Parekh era. The lack of divorce between ownership and management like the Ramesh Gelli owned Global Trust Bank where the owner himself managed the business also exposes a lending institution to bankruptcy and liquidation risks.

It is not difficult for a bank to generate a high rate of growth because there is never a shortage of people who want to borrow money from a bank, hence in case of a lending business, a company that grows at 30% should prima facie be preferred to one that grows at 40%. Consider the case of Axis bank and HDFC Bank in 2007; while both diluted equity at the same time, HDFC Bank deployed the proceeds slowly over a period of time whereas Axis Bank was quick to put money to work. HDFC Bank's argument was that it did not want to create an asset book that was lumpy with loans lent out during a specific year. *The fear was that if it lent more in a certain year then its loan book ran the risk of becoming bad if that year were to see a sudden decrease in economic activity.* In the ensuing 2008 crash, Axis Bank which had grown its asset book more aggressively by lending out in bulk to real estate, infrastructure and the small & medium enterprises (SME) collapsed 75% whereas HDFC Bank which had a more balanced retail and corporate loan book exposure fell 50% from the top.

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SEASONING OF LOANS:

There is something called seasoning out of loans for these lending agencies. An asset book which has gone up in the last one year is looked at with more suspicion than an asset book which has increased evenly over a longer period of time as borrowers don't default on loans in the first year of receiving it and hence the NPA as a percentage to total loans will optically show a lower figure as these loans will not have been seasoned out. Additionally, a book value made up of capital raised by QIPs and private placements will be valued less generously than a book created exclusively out of retained earnings.

HOW DO BANKS MAKE MONEY?

The raw material of the banking business is 'cash' which makes banking a thoroughly commoditised business as the borrower does not care whether he gets money from a Bank of India or an ICICI Bank, all that he looks for is a lower rate of interest. The bank borrows money and lends it to someone who it thinks will return it back as per the terms of agreement. Hence, to create shareholder wealth, a bank has to ensure that:

a) On the asset side, it manages its risks by keeping delinquencies in check.

b) On the liabilities side, it is able to get low cost deposits as a part of its borrowing program.

c) On the expense side, it keeps its operating costs in control.

FOCUSING ON ASSET QUALITY:

The non performing asset (NPA) ratio remains the lead indicator of the asset book. While the gross NPA tells an investor about the overall level of delinquencies the net NPA indicates the amount of bad loan waiting to be written off, from the books of accounts. A bank that has a gross NPA of 2% and a net NPA of 0.5% indicates that the bank has written off 1.5% of its bad loans against its income which is 75% of the total bad loans. This write off

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is referred to as the provision coverage ratio (PCR). The RBI stipulates all banks to have a PCR of at least 70% and banks that have a PCR of less than that will have to increase provisioning and hence get impacted by reporting lower profits in the subsequent quarters.

On the other hand, banks that have a higher than stipulated PCR and a low level of net NPA report higher future earnings as they recover their old dues for which a provision has already been made in the accounts. Such recoveries are then added back to the profits, for example Gruh Finance maintains a zero NPA and each recovery of old dues incrementally adds to the net profit of the subsequent quarters.

In addition to NPAs, investors should also look at the restructured assets. These assets are not NPAs in the technical sense but are accounts for which the bank has restructured the repayment schedule for payment of interest and principal. *Many banks hide their NPAs under the restructured assets so many times a restructured asset is like an NPA in veil.*

An investor should also read the annual report or go through the investor presentation that these lending agencies release from time to time to understand the break up of a bank's asset book. In times of an economic slowdown, banks that have a higher lending to the interest sensitive sectors like basic industries, power, real estate, infrastructure or the small and medium scale manufacturing units have to deal with a relatively larger risk on their asset book.

BUILDING A RETAIL BOOK ISN'T EASY:

Retail assets are considered to be of relatively better quality but scaling up a retail portfolio needs distribution and network which cannot be built overnight whereas for large sized project lending it becomes easier to deploy cash in bulk. Retail assets are generally more resilient in India when compared to the rest of the world because the penetration of consumer loans is still very low here. *Though a person might default on his large business loans he would attempt to regularise his relatively small dues on consumer durables, vehicles etc by either dipping into his savings or by borrowing from friends and*

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relatives. Additionally, most of the retail loans are made to people who would be professionals working for large organisations and though there is some degree of employee displacement during times of an economic slowdown, salaries have to be paid first before meeting other expenses. This makes salary income more stable than the company's business income and consequently retail advances become less risky than the corporate loans.

A strong retail base also helps a bank in generating a sustained stream of fees income by making commission from selling insurance policies, mutual funds and providing other wealth management advisory services. These products provide the bank with income without employing any capital and hence the incremental addition to the return on asset from distribution of these products is significant.

THE CASA RATIO:

The CASA ratio of a bank indicates the extent of low cost deposits. Within the CASA its the CA(current accounts) that is really low cost while the SA(savings accounts) isn't as low cost as was earlier the case. These days banks like Yes and Kotak offer higher savings deposits of 7% and 6% respectively which has diluted the significance of savings account deposits as a means of low cost funding. Good banks with strong liability franchises (depositor base) like HDFC Bank, Axis Bank, Punjab National Bank and SBI have a CASA ratio of more than 40% which helps in reducing the overall cost of borrowings.

A bank with a lower percentage of CASA deposit manages its shortfall by borrowing from the wholesale debt market. Such banks have to bear with the increasing cost of deposits when interest rates are on an upswing as their borrowing costs are linked to prevailing interest rates. Banks like Yes and Indusind which currently have low CASA deposits have a greater reliance on wholesale borrowings and show greater earnings volatility when compared to a high CASA entity like HDFC Bank. Due to this, the stock price of these low CASA banks falls more during periods of rising interest rates and rises faster during periods of falling interest rates.

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A bank which has a higher CASA ratio is more likely to have a larger retail deposit base. Retail depositors which include professionals and salaried employees are the kind of depositors who maintain reasonable balances in their current and savings accounts thus providing the bank with low cost funds for operations. A high retail deposit also facilitates the creation of a strong retail loan book. A bank may have a hard time evaluating the credit worthiness of its customers unless it has access to their banking accounts so a scrutiny of their banking accounts provides important insights on average balance, salary, income credits and frequency of cheque returns etc which can be used to control the accounts and also corroborate with the income proof of the borrower.

The CASA ratio also swings with the interest rates because when interest rates are high people prefer to remove money from their savings and current account deposits and put them into fixed deposits whereas in times of lower interest rates the propensity to swing that money away into fixed deposits isn't too high.

FIXED AND FLOATING RATE ASSET BOOK:

The composition of the advances also plays an important role in determining the profitability of a bank. *Banks like Indusind which have a greater percentage of fixed rate commercial vehicle loans suffer more during times of rising interest rates because even though they may have to borrow at higher rates the same cannot be passed through as their lending rates are fixed.* So while an Indusind benefits in a falling interest rate environment due to fixed lending rates, it loses in case of a rising interest rate environment. On the other hand, HDFC Bank has managed its asset and liabilities quite well as it has a greater percentage of its borrowings and advances under floating rate which keeps its margins secured against fluctuations from interest rate movements.

BUY BANK STOCKS THAT DILUTE EXPENSIVE EQUITY:

A bank that dilutes equity at a high price to book is an instant rerating candidate. Axis Bank and HDFC Bank went up in 2007, just after they made a near $1 billion and $660 million equity dilution respectively at over 5 times

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price to book. While Axis Bank almost doubled up post the dilution, HDFC Bank moved up more than 50% in the next six months.

When a bank dilutes expensive equity it raises the overall value of the book and makes the stock look cheaper on the post dilution price to book basis. On the other hand, PSU banks diluting equity at nearer to their book value see negligible impact on the book and hence those stocks do not move that much either. Analysts do argue that having cash on balance sheet isn't the same as deploying the cash in the market but it generally takes twelve to eighteen months for a bank to deploy its incrementally raised cash. However, the three things to remember for an investor who intends to gain from a bank that dilutes expensive equity are:

a. The equity should be diluted at a very high price to book value. A bank that issues capital at 5 times book is a better stock price appreciation candidate than a bank that raises capital at 2 times its book.

b. The quantum of dilution should be large when compared to the present net worth (book value). A bank that raises capital equal to 70% of its existing net worth is a better price appreciation candidate than the one that is raising incremental capital for 20% of its net worth.

c. The bank with a RoE of more than 20% is a better rerating candidate than a low RoE bank, as markets don't pay higher multiples for low RoE banks.

WHAT ELSE TO SEE?

- An investor should check the market price as a multiple of the book value. This varies from less than one time for second tier PSU banks to four times for stable high quality private names like HDFC Bank. However, there is no guarantee that a bank with a low price to book is always a better option than the one which trades at a higher price to book multiple. A bank is generally valued at a low price to book because:

  a) It generates a low Return on Equity (RoE) even after using large amounts of leverage.

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b) It does not have enough predictability of growth because of its past history or due to a low capital adequacy ratio.

c) The market expects a sudden and unexpected deterioration in its disclosed asset book which would reduce the book value from what it is currently assumed to be.

Irrespective of all the arguments of quality, everything is good at a price only as HDFC Bank traded sideways for 3 years from 2000 to 2003 as it was bid up to very high valuations and Yes Bank after hitting a price of ₹260 in December 2007 where it was trading at a PE of 40 times and a price to book of around 6 times on Fy 2008 numbers has returned an annualised return of just 3% till 2014. This is even less than what the bank gave on its fixed deposits.

The reason why most PSU banks trade at almost their book value in spite of generating a RoE of more than 15% is because:



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non recurring in nature and arises primarily out of buying and selling bonds in the open market.

- The RoA above, when multiplied with leverage gets us the RoE which for most banks stays between 16% to 18% and for exceptionally well managed banks moves to around 22% to 24%. As the RoE can be enhanced by taking higher leverage the RoA is the number to look out for.

- The net interest margin (NIM) is like the gross margin of a normal business. Banks engaged in unsecured retail lending generate higher NIMs but also suffer from incrementally higher bad loans which balances out the high margins. In general, the NIM hovers between 2.75% to 4.25% with the better managed banks generating a NIM of 4% and above. The NIM is disclosed by the management but can be computed by the following formula:

$$\text{NIM} = \frac{\text{Net Interest Income (Interest income – Interest expenses)}}{\text{Average earning assets}}$$

- The cost to income ratio indicates the level of operating cost for each rupee of income. Generally, a ratio of less than 45% is considered adequate for generating efficiencies of scale. A bank that opens up a lot of new branches will see this ratio increasing till the time the new branches become commercially viable for operations. On an average, it takes between twelve to fifteen months for a new branch to achieve break even.

$$\text{Cost to Income ratio} = \frac{\text{Operating expenses}}{\text{NII + Non interest income}}$$

- *A lower price to book with a higher net NPA may not be too different from a higher price to book and a lower net NPA. An investor should therefore adjust the book value with the net NPA to find the adjusted book value.* This is found out by reducing the total amount of absolute net non performing loans

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from the shareholders funds and then dividing it with the number of shares in issue. If the absolute net NPA figure is not given then it can be obtained by multiplying the net NPA percentage with the total advances.

- Generally, a bank that trades on a high price to book should not be giving out dividends. Cash is raw material for a bank and a bank that trades at 3 times book and pays out dividend of say ₹1 reduces its book value by more than ₹1, as dividends reduce the shareholder funds by more than what he receives due to the payment of dividend distribution tax. However, as the market price of a stock is set on a multiple of its book, the loss in market cap on account of this dividend will be more than ₹3. Banks that trade on a price to book of close to ₹1 should declare dividends while shareholders in a bank trading at below book (like the second tier PSU names) will make great deal more if the bank were to wind up operations and declare the entire book as dividend!

- Capital Adequacy ratio (CAR) indicates the percentage of owners capital as a percentage of risk weighted assets. The bank's CAR is inversely proportional to its leverage on balance sheet and beyond a point the leverage cannot be increased as the RBI prescribes a minimum level of CAR below which these lending agencies are not allowed to go. Each of the advances that the bank makes is adjusted for the risk weight which is stipulated by the RBI from time to time. For instance, a priority sector loan comes with a lower risk weight than an advance to a real estate developer. The CAR also indicates as to how long the bank can continue to grow without raising further capital. As the CAR approaches the RBI's stipulated ratio, the bank's ability to grow at rates higher than its (RoE – payout ratio) gets challenged unless it dilutes further equity to shore up its CAR.

$$\text{Capital Adequacy ratio} = \frac{\text{Tier I capital} + \text{Tier II capital}}{\text{Risk weighted assets}}$$

Overall, just like other sectors there is no single formula to value a bank stock. In a business where leverage runs at ten times the owners capital, investors have

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to be more focused on lending risks than on the profitability and valuation ratios. Investors should generally not hesitate to pay up a little more for quality and stick to banks that have a higher RoA and a better growth trajectory than banks working on low RoAs and meagre growth. The price to book like the PE ratio will always be higher for banks that are expected to deliver superior earnings growth and hence ignoring high price to book banks for their cheaper cousins is in most times a mistake.

NBFCS:

Analysing a NBFC is quite similar to analysing a bank as both are lending businesses with a focus on risk management and profitable growth. NBFCs should therefore be evaluated by looking at the NIMs, RoA, RoE, price to book and the P/E ratio etc. Unlike banks, which cannot have more than a certain percentage of their advances in a particular sector NBFCs are specialised lending agencies which focus on a certain sector so HDFC is focused on mortgages, Bajaj Finance on consumer loans, Manappuram & Muthoot on lending against gold, Sundaram Finance & Shriram Transport on commercial vehicle lending, Mahindra & Mahindra Financial Services on rural lending, Gruh Finance and Repco Home Finance on small ticket semi-urban and rural mortgages. This specialisation makes it easier for an investor to pick his spots and buy stocks from the sector that he is bullish on. However, being specialised lending agencies, NBFCs also suffer from concentration risks so when gold prices dropped to ₹25,000 per 10 gram from ₹33,000 per 10 grams the risks of asset recovery caused the gold financiers to be pushed down in price. One basic difference that a NBFC has with a bank is that while banks come under a direct and more rigorous control of the RBI the NBFCs are generally allowed to work with relatively more freedom as they are not subjected to CRR, SLR, priority sector lending and other restrictions of the RBI.

CONSUMER AND COMMERCIAL VEHICLE FINANCIERS:

A consumer durable financier like a Bajaj Finance or a commercial vehicle financier like a Shriram Transport is relatively a difficult business to execute as the price of the underlying asset falls as soon as the product rolls out of

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the showroom. These financiers consequently need to recover a higher rate of interest to offset the loss in recovery. The net interest margin would therefore be higher in case of these companies than when compared to a mortgage financier. This high NIM is however adjusted with the relatively increased level of defaults so the net effect isn't that lucrative as it seems at first glance. As consumer durables are discretionary in nature while commercial and consumer vehicles sales are linked to the overall economic growth, companies financing these products are subject to more rigorous swings in business cycle than the more steady home loan financiers.

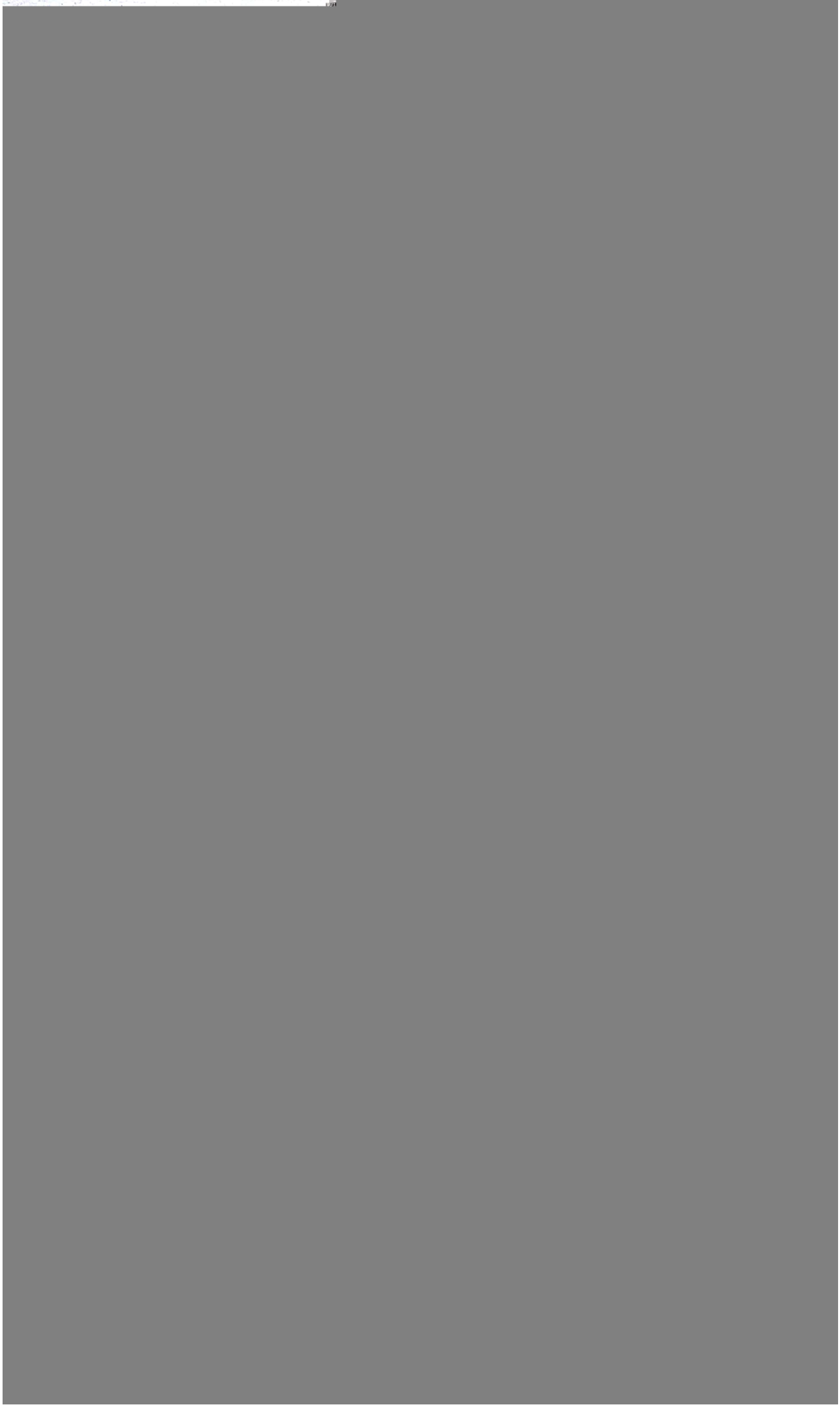
GOLD LENDING AGENCIES:

Similarly, gold lending companies carry a higher degree of risk as people generally borrow against gold when they exhaust all other avenues of financing. *Additionally, the strong underlying security in gold ensures that unless the price of the collateral falls drastically there is little risk to this business.* However, as gold forms a large part of the import content, lending against gold is always subject to regulatory risks of control. Overall, the business of lending against gold is more like a secured personal loan.

MORTGAGE FINANCIERS:

As having a home is a necessity people don't postpone having their first home which keeps the mortgage financiers especially the small ticket size home buyers relatively insulated from business cycles. This coupled with the low penetration of mortgages in India makes it a long term story. Firstly, the prevalence of the cash component in home purchases ensures that the underlying assets under mortgage is always worth a little more than what it has been valued at. Secondly, real estate is an appreciating asset in India and with time its value increases which protects the lender's interests. Thirdly, each month of instalment payment reduces the value of the loan which further strengthens the asset book by increasing the margin component of the asset. These three things working together makes investing in mortgage financiers a profitable long term opportunity. But the economics of the business is maintained only if the mortgage financier sticks to financing individual home buyers and restrains from extending builder and developer

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WHEN TO USE A P/E RATIO AND WHEN TO DO A PRICE TO BOOK?

The consistent struggle among the investor community is the method in which these banking and NBFC stocks should be valued. While a majority of analysts use the price to book method, the strategy of painting everything with the same brush is incorrect and faulty as different companies have different strategic positionings and there cannot be a one size fits all. As the RoE is the true indicator of capital efficiency an investor should value these banks in relation to the RoE that the business generates.

The above statement can be explained by the following example. Consider an investor who does a fixed deposit of ₹1,000 at an interest rate of 8% to earn ₹80 while generating a pre tax RoE of 8% (80/1000x100). Now if a 30% tax is deducted from this income, the post tax RoE comes to 5.6% for which his fixed deposit is valued at par or at ₹1,000.

If this investor were to instead buy the share of the bank in which he was doing a fixed deposit the price that he would be comfortable paying up for it would be a function of the RoE that the bank earns on its investments. If the bank earns a RoE of 11.2% an investor would be comfortable paying up to 2 times the book because at that rate a price of ₹2,000 fetches ₹1,000 of book value on which the bank generates a RoE of 11.2%. The value thus created of ₹112 is equal to 5.6% on his total investment of ₹2,000. The price to book of 2 times seems fair as this 5.6% was also the post tax yield of his fixed deposit. So the price to book that a bank will trade at is actually a function of its RoE or in other words, a bank or a NBFC generating a 35% RoE could trade at 6.25 times (35 / 5.6) price to book which also explains why a 35% RoE stock like Gruh Finance consistently trades at above 6 times book. The valuations of Gruh Finance actually shot up after the company's RoE started expanding from Fy 2010 and once the stock was being valued on this parameter it appeared that the market was valuing it on a P/E basis.

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THE VALUATION OF GRUH FINANCE EXPANDED WITH ITS RoE

	2013	2012	2011	2010	2009	2008	2007	2006	2005
Market price as on 31st (₹)	210	127	72	44	19	31	27	19	9
RoE	33%	34%	31%	28%	24%	24%	24%	27%	24%
Price to book (times)	7.61	5.83	3.96	2.86	1.47	2.81	2.9	2.85	1.63

*Financial years

Another fault with valuing stocks on a price to book is that it penalises companies that declare generous dividends. In the case of Gruh Finance the company has a policy of distributing 30% of its profits as dividends which reduces the shareholder funds and hence the price to book optically looks higher buoyed by a smaller book value. Had Gruh Finance not distributed the dividends but retained it in the business its book value would have been higher while valuations would have appeared more reasonable than what it does at present.

SPECIALISED NBFCS CAN DO BETTER THEN BANKS:

The specialised NBFCs continue to compete against the large banks because of their distribution and reach. Most of these institutions have years of experience in semi urban and rural India and as a major chunk of the rural population is under penetrated it might take a lot of time for banks to focus on these niche segments.

Unlike a bank, a NBFC has no CASA so the cost of funds remains in focus. In any case, a NBFC has a higher rate of NIM when compared to a bank because it is not obligated to maintain a cash reserve ratio nor a statutory liquidity ratio. The regulatory control on banks are much more than that of NBFCs which makes banks a very long term business to bet on as the RBI keeps

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monitoring it on a day to day basis. However, the business model of a NBFC is equally robust and tested as it has the ability to generate higher rates of growth at reasonable RoEs for very long periods of time. Together, a well managed bank or a NBFC remains the best way to compound returns year on year - without any permanent interruptions.

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Chapter 35

COMMODITY CYCLICALS ARE NOT LONG TERM BETS

A cyclical would look most attractive when it ought to be sold and appear most unattractive when it ought to be bought.

The argument about investing being a long term phenomenon does not apply to commodity stocks in as much as it does to companies whose earnings are secular in nature. As the price of a stock tracks the movement in its earnings, a stock with a cyclical or a non-secular earnings flow will also report a price trajectory that is in confirmation with its erratic earnings. The inability of the investor to frame an opinion on the movement of the underlying commodity prices on whose basis these stocks fluctuate, makes commodity cyclicals one of the trickiest sectors to analyse, understand and profit from.

One of the piquant aspects of a commodity business is the severe lack of entry barriers and the complete absence of pricing power making these commodity producers 'price takers' rather than 'price makers'. *Over a longer period of time, commodities generate only as much as inflation but as these returns come to an investor in short bursts of time they appear magnified either way, depending on whether the underlying commodity is on an upswing or a downswing.* Strangely, the retail community in India confuses many commodity stocks as blue chips and not as cyclicals just because of the promoters that owns them. So an old timer would consider an ACC, Tata Steel, Tata Chemicals, Grasim, Hindalco etc as long term blue chips whereas in reality these are cyclicals which because of their erratic earnings, managed to create only a fluctuating price performance. Even Reliance Industries with its chemical, oil exploration and refining business is a commodity stock but is nevertheless accorded a blue chip status by many old time investors. Interestingly, all these stocks were blue chips during the license raj regime

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where setting up a new plant or expanding the capacity of the old one required government permission. This prerequisite of getting a government approval created an entry barrier for all existing businesses. As the markets opened up after the economic liberalisation of 1991, these companies were reduced to mere price takers or pure commodity cyclicals.

Cyclical stocks make up more than three quarters of our market. The term cyclical isn't used to cover just commodity producers like steel, oil, copper, zinc etc but extends far beyond it to include real estate, construction, shipping, commercial vehicles, banking and capital goods. Therefore, the arguments made here will extend to most of the sectors in the Indian market.

CHEAP VALUATIONS:

Cyclical businesses will generally be available cheap. *The low P/E of such businesses originates from the unpredictability of their earnings stream and hence comparing the valuation of a cheap cyclical business to that of a relatively expensive secular growth story is incorrect. Cyclical businesses should be bought when they are doing badly and should be sold when they are doing well assuming of course that the company bought during bad times isn't headed straight into bankruptcy.* As the business environment for these stocks swings far more quickly than investors can forecast, most cyclical companies reward the short term buyer and penalises the long term holder which is contrary to the normal stock market practice where the long term buyer is rewarded at the cost of the short term punter. So if someone bought Tata Steel in early 2003, his annualised return from the investment has only been 13% despite the fact that the last ten years have been phenomenal for global commodities. Meanwhile the Sensex has during this period, returned an annualised gain of around 20%.

DEMAND SUPPLY DYNAMICS:

Another aspect that governs the investment in cyclical stocks is a lack of exhaustive valuation technique as to when such stocks should be bought and when they should be sold. One cannot run a cash flow analysis on them or value them for dividend yields nor can any forward P/E be assigned to

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them as these stocks cannot be estimated for future earnings with any degree of predictability. As cyclical stocks are valued on the basis of their underlying commodity prices an investor who buys cyclicals should therefore buy or sell them when the price of the underlying commodities are nearer to the turning points, an event that is known only in hindsight while the effort remains to pick them out in foresight.

Commodity prices generally remain rangebound for long periods of time and when the price of these commodities fall, most of the firms producing them start incurring losses due to which the EPS moves down lower and the P/E's move to the higher levels. But falling commodity prices compels a lot of these firms to close down operations due to the deteriorating economics of the business which decreases the supply of the commodity from the market. However, lower commodity prices also increases the demand for the commodity and once the demand supply equation stabilises it causes commodity prices to recover and move back higher.

On the other hand, when commodity prices are moving higher, a lot of new supply enters the market as marginal firms become economically viable to produce while entrepreneurs get encouraged to put up new plants in the backdrop of rising prices. For instance, a rise in price of gas has encouraged the U.S to extract the same from bed rocks which would have become unviable if gas prices were to see a steep decline again. When supply increases beyond a point, it puts incremental pressure on prices while higher prices generates a downward force on demand as producers find it difficult to pass on the effect of rising prices. Meanwhile, higher prices creates record earnings for commodity companies leading to a drop in the P/E ratio which is minimum at the top of a cycle. This demand supply dynamics helps to restore equilibrium by increasing supply when price is above equilibrium and decreasing supply when it is below it. *Unlike a secular growth business the P/E ratio for a cyclical commodity contracts in good times and expands during bad times because the markets know that these good and bad times are bound to change on an industry level though on an individual level the probability of corporate mortality increases each time the sector goes through a downtrend.*

However, a low P/E for the top and the high P/E for the bottom are just indicative measures that the cycle is somewhere near the top or the bottom

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but there is no foolproof formula for evaluating how low a P/E should become or how high it should go to, before it changes course again.

GETTING BOTH THE ENTRY AND EXIT RIGHT:

Identifying the turning points for these commodity cycles isn't easy which causes most investors to end up losing money in cyclical companies. The time to buy and sell a Tata Steel is vastly different from the strategy an investor would adapt in buying a ITC. The first problem that arises from owning cyclical companies is to time the 'entry' and the second problem lies in timing the 'exit' much unlike the secular growth companies where an investor has to just get the 'entry' decision correct. This is because once a secular growth story has been identified and bought, an investor can stay with it for years unlike a cyclical stock where the profitable holding period comes with a limited shelf life.

Another way to look at cyclical stocks is to see their operating margin and RoE's which will be highest nearer to the top and lowest at the bottom. *For the stock market investor the higher operating margin and the expanded RoE of a cyclical stock is not a signal of strength but one of threat, whereas the lower margin and the depressed RoE remains a signal of opportunity as they indicate the nearing of turning points.* However, an investor should analyse the RoEs and the profitability ratios of the sector leaders as the second and third liners might be struggling with their own problems.

Cyclicals should form a small part of the overall portfolio allocation and should be bet only if the investor understands the cycle. In case of a turnaround one should bet on a cyclical after it has started to show visible signs of turning around rather than in anticipation of the turnaround even though such a strategy might mean giving up a part of the rally. Then one should evaluate and back up those companies that are making profits on an operating or the EBIDTA level and that the EBIDTA is at least 1.5 to 2 times the interest costs because buying a company that has an EBIDTA equal to its interest costs puts the business under threats of survival if a) interest rates on existing debt or the absolute level of debt were to go up; b) the price of the underlying commodity were to fall further or c) the company faces a situation of rising

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input costs which it is unable to transfer to its customers, though in the long run all costs are transferable.

LOOKING AT THE COST OF PRODUCTION:

While buying cyclical stocks an investor should look out for the lowest cost producer as the lowest cost producer will be the last company to go bankrupt during a downturn. Additionally, the low cost producer also makes the maximum margin on recovery. However, as indicated earlier it is always better to be a little late in playing for recovery than risk being a little early for the same.

On the other hand, the high cost producers are the first to close shop when the situation deteriorates as falling commodity prices makes it unviable for them to continue producing beyond a point. An investor who is willing to take some risk should, on recovery be buying companies that have a high cost of production and carrying a large debt on balance sheet. These companies are well priced for bankruptcy risk and when the cycle improves the bankruptcy risks recede giving rise to a fast and quick price recovery which leads these debt heavy companies to outperform their debt free, low cost peers.

But as turnarounds seldom turn around, one has to be very careful in playing the turnaround game.

THE SUPPLIERS TO CYCLICALS ARE NOT ALWAYS AS CYCLICAL:

Even though a supplier to a specific sector acquires the positive and negative attributes of that sector a company supplying to a commodity cyclical might still retain its brand and pricing power. Mining equipment manufacturers like Ingersoll Rand and Atlas Copco were high RoE businesses even while the mining companies that used their products suffered from cut throat competition all the time. Similarly, the engine supplier, Cummins possesses tremendous entry barriers with pricing power even while the user industry suffers from acute unpredictability with respect to business forecasting. Engineers India and Aban Offshore were also better businesses than the

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traditional oil companies and so were the tyre manufacturers like MRF and Balakrishna Industries even while their users remained classic cyclical plays. The advantage in playing the sector theme through the suppliers is that even though the typical cyclical stock runs the risk of getting into financial distress these high quality suppliers seldom get into acute trouble unless the management gets too ambitious and attempts to grow beyond its means by making one or more, major judgemental errors.

VALUATION MATRIX:

When cyclicals start hitting their lows they should be evaluated on a market cap basis. At the troughs, cyclicals trade at high P/E multiples and at low market caps so instead of worrying too much about the high P/E an investor should look at the low market caps to take a broad business call. *A cautious investor should also add the debt of the company to the market cap to arrive at the enterprise value to get an overall sense of business valuation.*

However, before buying a steel company, an investor should ensure that the business has its iron ore and coal linkages in place. Ultimately steel prices are just an incremental addition of the conversion cost to the raw material used. Due to this, steel prices generally move up when iron ore and coal prices are on an upswing and a steel plant without captive raw material backup finds it difficult to survive independently over longer periods of time.

COMMODITIES NEVER GO TO ZERO:

In case of a cyclical company the idea is to capture the upside in the underlying commodity. However, two things distinguish betting on a cyclical stock vis-a-vis the underlying commodity a) a stock can go to zero but a commodity can never go to zero and b) the rise in price of a commodity stock because of a relatively stable cost structure will be much sharper than the rise in the price of the actual commodity. While the lowest cost commodity producer protects the downside in times of a strained economic environment the high cost producers return the maximum profit for investors. The viability of the high cost producers increase with the rise in price of the underlying commodity and the market reprices it on the basis of continuity rather than assuming the company to go into bankruptcy.

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Finally, for commodity cyclicals one has to keep an eye on the government's policy of duty and drawbacks on the import and export of the specific commodity. A change in import and export duties never gets a stock a higher multiple as the market is always apprehensive about the long term continuity of a government decision. Overall cyclical investing needs a hit and run kind of strategy where an investor needs to buy the stock and then sell out as soon as he makes a lot of money as holding a cyclical stock for a multiple year time frame will normally generate only a moderate rate of return.

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"In a bear market every bout of short covering looks like the beginning of a new bull market!"

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Chapter 36

ANALYSING HOLDING COMPANIES

Investors can make money from a cheap stock only if they can identify a catalyst that will make the cheap stock expensive.

Holding companies are those listed entities that own majority shares in other companies and are generally traded at a discount to the value of the investments that they hold. The holding company discount remains the most unexplored areas of investing as the discount swings wildly from 10% on one side to as high as 75% on another. The discount of the holding company varies depending on the ownership structure, dividend receipts, business prospects and the overall mood of the market. These companies represent the easiest value hunting opportunity as like analysing companies with cash on balance sheet there are no assumptions to be made, no growth rates to be forecast, no competitive dynamics to be analysed which makes it an instant hit with the new investor who is attracted by the optical surety of the valuation gap. As an investor matures, he learns from experience that except for a few isolated cases these gaps remain and that making money from apparently cheap stocks isn't as easy in real life as it seems on paper.

In order to make money on a holding company stock an investor should first be bullish on the subsidiaries of the holding company, in which case one also has the option of buying the subsidiary instead of its listed parent. An investor in these holding companies would make incrementally more money by buying the parent instead of the subsidiaries, only if the valuation gap between the market value of the parent and the value of the holdings narrows down from the time of his purchase.

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Most of these holding company stocks underperform the broad markets. This is because these companies are generally set up as shell companies from where the promoters hold, operate and manage the subsidiaries even as the minority shareholders of the holding company are short changed for the benefit of the majority promoters.

Unless the discount is significant and runs a reasonable chance of narrowing down, an investor will generally hurt himself in trying to buy a rupee worth of asset locked up in a holding company structure and available for less than that.

Some holding companies function as quasi close ended mutual funds. Tata Investment is one such entity which owns shares of most of the Tata group blue chips. Investors who buy shares of Tata Investment get immediate ownership for a larger value of various Tata group companies as the price of the stock remains at more than 30% discount to the market value of its holdings. However, as this company is invested mostly in the dividend paying blue chips the yield from buying the holding company stock at a discount to its value of investment will be more than that obtained by directly buying the underlying shares.

In 2002, I used to own a company called Hinduja TMT which was engaged in the business of providing BPO services to clients across the globe. While the original thesis of my investment was to buy the company for its BPO business I was later attracted to it because Hinduja TMT also owned a small 6% stake in the mobile service provider 'Hutch' a company that was later acquired by Vodafone. As I was bullish on mobile telephony as a business I continued to own Hinduja TMT as a proxy for playing the mobile telephony business. My investment in the company was also a result of its cable TV assets as the news of digitisation was just appearing to surface. The cable TV industry suffered from large amounts of undeclared revenues and digitisation was estimated to benefit both the broadcasters and the distributors in a big way by improving transparency in reporting the actual number of subscribers. Despite my bullishness, the stock of Hinduja TMT continued to perform in line with its basic BPO business only as the market gave it no credit for its cable TV assets and the small stake in 'Hutch'. The two lessons here were that a) an investor should not buy a business unless it has started to make money

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as even after ten years the industry continues to wait for addressability or CAS as digitisation was then called and b) a company gets valued for large majority stakes and not for the small and insignificant minority ones.

Most holding companies have over the past few years done far worse than the broad markets. Companies like Williamson Magor which has a stake in Kilburn Engineering and trades at a price significantly less than its value of investments has generated an annualised return of only 13% since 2003 which is a lot less than even the Sensex, while in the same period Maharashtra Scooters which trades at discount of over 50%, to the value of its holding in Bajaj Auto has done worse than Bajaj Auto.

An investor who fancies these discounts can also buy a Bajaj Holding with a near 50% discount to the market value of its investment but the problem with these companies is that the discount tends to remain and the best that an investor can make is the same as he would by betting on the underlying stock that the holding company holds. Therefore, if an investor is bullish on Bajaj Auto, it is better to buy Bajaj Auto rather than Bajaj Holdings, if he is bullish on Kilburn Engineering or McLeod Russell then one should buy these stocks, rather than their holding company though in theory, the holding company would appear to be a cheaper bet.

Another drawback of investing in a holding company structure is that the promoter of a holding company with listed subsidiaries does not pay too much attention to it. This is because the management remains focused on expanding the competitive dynamics of the subsidiary rather than in unlocking the value in the holding company.

Moreover, a holding company structure allows the management to exercise majority control with minimum capital. Imagine a promoter Mr. P having a 51% stake in H Ltd. Now, if H Ltd owns 51% of S Ltd, the owner Mr P controls S Ltd by effectively putting up only around 26% stake. This is what happened in Network 18 where the promoter Raghav Bahl created a web of holding companies while converting his 26% minority holding in Television Eighteen to a majority by creating a holding company structure with Network 18 in between.

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WHAT REDUCES THE DISCOUNT?

In case the holding company structure is a necessary setup to extend the operating activities of the company the market does not reduce the valuation, as it does, when the motive to set up a holding company structure is to merely exercise control over the operating business. The key to buying holding companies is to look for those entities that consolidate earnings from their subsidiaries. Companies can consolidate earnings when they own 51% or more shares or voting rights of the subsidiary so buying a company that has a 50.99% stake of another company isn't the same as buying one where the stake extends up to 51%. Several large multinationals like Unilever, Nestlé and even our own Sun Pharmaceutical are holding company structures but as they have majority ownership in the subsidiaries, these companies are not subjected to the discounted valuations. *Additionally, as the subsidiaries of these companies are not listed in the same market as that of the parent nor is the parent listed in the same market as the subsidiary, the investors have little choice than to buy the respective stocks on merit.*

Holding companies with unlisted subsidiaries are generally a better investment option than a holding company with a listed subsidiary, assuming of course that the subsidiary is the crown jewel that most investors want to own. A holding company with a more valuable unlisted subsidiary will continue to be in demand even if it has another subsidiary which is listed but not as valuable as its unlisted sibling.

As holding companies are mostly valued on the basis of consolidated earnings putting the value on the basis of the sum total of market cap of subsidiaries isn't the right thing to do except in cases where the the holding company owns less than a 51% stake. In some cases, investors do a sum of parts valuation as it happens with L&T or a Tata Motors but even there, it is better to focus on price as a multiple of earnings per share rather than valuing each business separately. Theoretically, one can do the sum of parts if the businesses are too diverse in character and nature as is the case of L&T where the infrastructure, finance and software businesses cannot be put under the same P/E ratio.

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A holding company whose subsidiaries pay a lot of dividends will always be valued at a lesser discount than a company whose subsidiaries do not pay too much dividend, that is because if the dividend yield of the subsidiary is 2% and the holding company goes into a 75% discount, then the yield of the holding company would be 8% which does not normally happen. *Therefore, the only case where the holding company discount would narrow down is when it consolidates its accounts and receives dividend from its subsidiary.* The dividend yield will also help to keep the price of the holding company in check, if it goes too far below a certain value.

WHY SHOULD THE DISCOUNT REMAIN?

Another argument to justify the valuation discount for a holding company is the capital gains tax. Assume a holding company valued at a market cap of ₹1,000 crores with a listed value of investments at ₹1,500 crores but if the company were to suddenly decide in selling off the shares and distributing the income to its shareholders by way of dividend, it will be subjected to capital gains and dividend distribution tax which could collectively extend to between 20% to 40% of the value depending on acquisition costs making the discount a theoretical necessity.

Finally, a holding company structure is an inefficient arrangement that keeps the shareholder value locked up till such time that the management of the company does not attempt to get into the value unlocking process through a spin off and unless the management makes efforts to unlock value the holding company discount can remain for days, weeks, months and even years.

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“A bank is valued not by how much loans and profits it can make but also by how much of that it can recover.”

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Chapter 37

PSU STOCKS

Companies under government ownership are given just enough to stay alive but never so much for their shareholders to enjoy life!

Post independence, India adapted the mixed economy system of economic structure, where the public sector was expected to co-exist and supplement the efforts of the private sector so as to initiate economic development on a larger scale. These state run units were expected to undertake investments in industries that had a long gestation period and needed a large dose of capital as the private sector neither had the capital to invest nor the willingness to wait for the returns. Subsequently, the government initiated the process of setting up businesses in oil and gas, cement, insurance and mineral resources as green field projects. This was followed by the nationalisation of banks and coal mining companies, all in a bid to rapidly expedite the process of growth with development.

These public sector units were set up as artificial monopolies, backed by government order and were expected to spearhead the process of growth. But in spite of having being allowed to function with negligible competition, most of these units have over the years fallen well short of their desired objectives due to the inherent drawbacks of operating a business that is regulated, influenced and stage managed both by the politicians and the bureaucrats.

Post liberalisation in 1991, the Government of India through its various disinvestment schemes has tried selling its shares in several of these large sized public enterprises. The idea of selling these shares to outside investors was to ensure that a) the government gets money to fund its budget deficit and b) these corporations are introduced to the stringent accountability

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norms of listed companies which would help improve their efficiency and increase profitability. However, the process under which these companies were initially disinvested was faulty and incorrect as the then finance minister, Dr. Manmohan Singh met his initial disinvestment targets by selling family silver (shares of government companies) at prices significantly higher to what they were worth, to the Unit Trust of India and the Life Insurance Corporation of India. As the funds at UTI and LIC were formed out of the savings of the general public this type of disinvestment was in some ways, a case of forcing the Indian public to buy over-priced shares of state owned enterprises. A few years later, US - 64, the flagship scheme of the Unit trust of India folded up due to other reasons but the foundation was already weakened by the act of buying overpriced shares of government companies.

Subsequently in 1998, the government created a cross holding structure where GAIL, IOC and ONGC were forced to buy shares in one another. It was a case of the government not willing to relinquish control and yet extracting the money too. A better strategy would have been to ask these companies to declare a one time special dividend. But letting these companies declare a one time special dividends would have resulted in sharing cash with minority shareholders which the government did not want at that time and hence



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In between these events, a lot of PSU companies were beaten down to very low levels of valuation in the late 1990's. Some of these stocks like Engineers India, Bharat Electronics, Shipping Corporation traded at ridiculously low valuations of low single digit P/E multiples and a high yield of 6% to 10%. These stocks aided by a favourable economic tailwind subsequently rose twenty to hundred times in a matter of a few years.

REGULATED INDUSTRIES:

Good companies can grow in free markets but not under regulated environments so a business under government control or influence should normally be avoided as it reduces the ability of the company to generate above average shareholder returns. This is because if the oil producing companies like Oil India and ONGC, make large amounts of money the government uses the excess earnings to subsidise the oil marketing companies like HPCL or BPCL and if they make less then they are given just about enough to stay in business. *While the minority public shareholders keep counting the number of petrol pumps and the value of the network they forget to realise that as long as these companies are owned by the government the value of the network will always remain buried under the paper weights of bureaucracy and populism.*

Consequently the overall level of wealth creation from these PSU units have been moderate to low except for the early part of the last decade when there was an overall buoyancy in the level of economic activity. Most government companies have since then continued to struggle and deliver on the promises that the minority shareholders assumed these companies to be making when they first bought them.

GETTING PUBLIC PARTICIPATION:

It is argued that small piecemeal disinvestments of large corporations serve no purpose as the corporations retain their inefficient mode of functioning and the little money that is raised each year makes a negligible difference to create any big change whatsoever. To expedite the process of disinvestment the government should sell its shares maybe at a 40% discount to market

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price to all Indian residents who own a Permanent Account Number (PAN) which is issued by the Income Tax Department. Such a step would encourage people to own and retain PAN cards and also file their returns which would broadbase the community of potential tax paying assessees. It would also facilitate the transfer of national assets to the people who own these assets and also widen the investing community by encouraging new participants to come into the stock market.

WHY NOT TO DISINVEST?

One argument that goes against disinvestment is that as long as the return on capital employed of total government owned assets is more than the cost of government debt then it is alright not to be rushing in to sell these pieces of family silver. In other words, if there is a lot of government debt sitting on the liability side of the government balance sheet then there are also these PSU companies available on the asset side of the balance sheet so it isn't that much of a disaster not to be selling these state run units as the stock market thinks it to be. The only loss of advantage that the nation faces by not selling these assets is the inability of these corporations to be as efficient under government control as they could have been in private hands.

THE BUSINESS MATTERS MORE THAN THE OWNER:

Most investors are reminded of the PSU stocks that made money for their investors between 1997 and 2008. A look at these stocks will make it clear that most of the money that was made was by the process of investing in companies at cheap valuations or which had a high degree of business tailwind and not by any other magic. While the infrastructure equipment supplier BEML was up 135 times from ₹13 in September, 2001 to ₹1,792 by December, 2007 the rise in price was led by an overall boom in construction stocks. The stock is now down more than 90% to ₹141 as on September 30, 2013. Similarly, the rally in other PSU stocks was a result of the overall bull run between 2003 and 2008 rather than anything specific with respect to these companies.

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The defence supplier, Bharat Electronics Ltd which also manufactures the electronic voting machines along with night vision glasses, radars etc moved up 114 times from ₹18 in March, 1999 to ₹2,064 by January 03, 2008. The stock has since fallen almost 50% to ₹1,074 as on September 30, 2013.

While CMC moved up 45 times from early 1997 till the peak of the tech bubble in March 2000, the stock even after being privatised has struggled to just triple itself over the next thirteen years. *This shows that over the long run the initial valuation and the underlying business prospects matter as much as the ownership structure in determining stock price movement.*

PSU stocks like Hindustan Zinc that were privatised did make tons of money for their new owners but this was more in the backdrop of an overall rise in global metal prices as the stock moved up 50 times between 2002 and 2006 whereas it has gone up only 50% over the next seven years. If privatisation was the only issue, a stock like Hindustan Zinc should have continued on its path of rewarding shareholders even after 2006!

This is much to the contrary of what the stock market thinks, as a great manager can add only so much to a lousy business and by imposing superficial price and operational controls the government has damaged the business prospects of many of these corporations. The recent power purchase agreement where Coal India was asked to subsidise the input costs of most of the private players by taking up the risks of fluctuating prices of imported coal is another proof of how the ownership of these state run entities are framing policies that are doing more harm than good to the minority shareholders.

Added to this, is the tendency of government companies to lose leadership to their private counterparts like they did in banking, telecom, television broadcasting, airlines etc.

Finally, as most of the PSU stocks are from the cyclical space they suffer from an inherent inability to reward their long term shareholders except in case of severe undervaluation and a robust tailwind, as was observed in the early part of the last decade.

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ITS TOUGH TO MAKE A LOT OF MONEY IN PSU STOCKS - OVER THE LONG TERM:

A genuine investor who picks stocks based on the numbers reflected in the balance sheet should remember that companies under government control can have their fortunes changed depending on which section of the society the government wants to favour. Therefore, if oil prices have moved up from $15 to $115 a barrel in the last ten years then shares of ONGC in spite of going up from ₹45 to ₹280 has underperformed the Sensex because it was never allowed to reap the benefits of rising crude prices. Coal India continues to sell coal at prices which are less than 50% of the price of internationally landed coal; BPCL, HPCL and IOC continue to bleed and are given just enough to survive from one financial year to the next, while PSU banks are randomly directed to engage in farm loan waiver or are forced to cough out dividends. The Government's diktat of forcing PSU banks for dividends is as cruel as compelling an anemic for blood donation! These state run banks declare generous dividends on one hand even as they remain starved for new fund infusion on another. Compared to this, the private banks do fund raising at will which helps the private sector take away market share from the PSU banks. Actions like these shift the competitive ability of state run enterprises in favour of their private counterparts which makes it challenging for an investor to make money from PSU stocks.

A serious long term investor should ignore most of the PSU stocks and all private companies which operate under the influence and regulation of policies as framed by the government as while the primary motive of the government is to be popular the primary motive of the shareholder in a government company is to be profitable and the mismatch of these motives ensures that any business connected to the government remains difficult to make money from - most of the time.

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Chapter 38

ANALYSING SECULAR GROWTH STOCKS

Identifying a great investment idea is as difficult as finding the right spouse but after you have found one it pays to stay on.

A secular growth company is one which promises a steady rate of revenue and profit growth for longer periods of time. The predictive nature of these businesses makes them trade at higher valuations when compared to the other stocks in the market. Most secular growth companies are free cash flow entities with entry barriers and use little incremental capital to regularly throw back lots of cash to their shareholders as dividends. These companies are home to the large number of wealth creating stocks and are found in sectors such as consumers, pharmaceuticals, IT Services, private banks, NBFCs and to some extent the two wheeler space.

Most secular growth companies go through a P/E expansion in the initial years of stock discovery. This P/E remains extended till such time that these stocks experience above average rates of growth. *An investor who can spot a secular growth company before it has actually been discovered by the market stands the chance of creating a retirement fund out of moderate amounts of deployed capital. It is not uncommon for these companies to increase earnings by ten times in the first six years of operation and expand the P/E by two, three or four times which takes the stock up by twenty, thirty or forty times in quick time.* This setup isn't difficult to find and comes every few years especially through the IPO market to an investor who is eager to look for such opportunities with a curiously open mind. However, such an investor should not be too eager to buy a rupee worth of merchandise at ninety paise as the trick to buying most of these secular growth names is to pay a little more for what it is worth today and hope to make good the difference through steady and consistent growth, in the years to come.

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Most of these high growth companies start as small caps and as their size increases, the growth slows down by which time their P/E also expands turning these companies into stable compounders thereafter. These compounding machines generate years of above average returns even after they have been discovered by the market but are still shunned by investors and analysts because they are not the typical deep value stocks that the average investor is so keen on identifying all the time. *The Indian analyst community though is a funny lot as they classify most of these secular 18% to 20% compounding stocks as defensives whereas in the real world it is a challenge to identify companies that can promise 20% or more growth year on year.*

PRICING POWER:

The ability of a business to raise prices continuously, with or without reason would qualify a company as having pricing power. Generally, a company will have pricing power if it can raise prices by 6% to 8% every year. The company which can retain its price increase without lowering them when input (raw material) costs fall will qualify as having the true test of pricing power. Page Industries, the Indian license for the Jockey brand of innerwear raised prices multiple times when raw material costs went up more than 30% in 2011. However, when raw material prices subsequently fell the management decided not to pass on the benefit of lower input costs to the consumers. A year later when the government increased excise duty, Page was seen increasing the price of its products again and when excise duty was rolled back Page retained its selling price, refusing to roll it back. Asian Paints takes small 2% to 3% price increases several times a year to offset the impact of high crude oil prices and so does GSK Consumer for its 'Horlicks' drink. Pharmaceutical companies have the maximum amount of pricing power as companies that manufacture drugs for specific diseases will be able to sell as much even if they increase prices but off late the government has been trying to regulate these drug companies from increasing prices through the DPCO (Drug price control order) but such regulatory diktats though negative in the short term do not change the long term character of the business.

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VOLUME GROWTH:

A business should always be capable of generating volume growth because prices can be increased only up to a point and not beyond. *Volume growth happens when the company can sell more units of the same product to both existing and new customers.* Many consumer companies handle economic swings by having an entire bouquet of products for customers from various income streams so as to retain them under all types of economic conditions. One example of getting different products for customers with different income level is Hindustan Unilever's three soap brands Lifebouy, Lux and Dove. All these products cater to a customer as he moves up or comes down the income ladder so when his income is small he can buy Lifebouy and then for every increase in income he can upgrade to the next level. On the other hand, if the customer wants to spend less because of a decrease in his overall income stream he can pick up a Lifebouy instead of a Lux or a Lux instead of a Dove which helps the company to retain its customer irrespective of the swings in the customer's income levels.

However, not all companies can create different products at various price points as each of these product will have to be sold through a different brand so in case of Titan watches the lowest price point brand is 'Sonata' which then moves to Fastrack, Titan, Edge and finally to Nebula where each of these products have been positioned differently so that a consumer gets a differentiated feel. Sometimes a company with a single brand positioned in the premium to sub-premium category finds it difficult to enter the mass market segment just as a mass market brand finds it challenging to upgrade to the premium category. A case in point is Jockey, which cannot sell as a mass market brand without diluting its brand appeal and Rupa which cannot sell in the premium category because irrespective of quality no one likes to pay more for a brand that has positioned itself in the economy range.

Another way of catering to customers from different income streams is by breaking the product into smaller sizes (sachets). As the price point reduces it starts becoming affordable to newer pockets but a company that has already broken its products into smaller sachets so as to cater to the customer group of different income streams cannot employ this tactic anymore as in some cases decreasing the size of the product below a certain level reduces

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the consumer's satisfaction level and works negatively for the company. Nestlé has been reducing the size of its Maggie noodles pack by constantly retaining the price at ₹10. Customer feedback has now suggested that repeated size reductions are now having a negative impact on the consumer's mind where he does not get satisfied after having a full packet forcing the company to increase prices, rather than decrease the size anymore.

Not all consumer companies function with the same set of economic advantages as standardisation of services is more difficult to achieve than standardisation of products. Marico's health and wellness arm 'Kaya' is still struggling to make up for all the years of effort that the management has put into it because getting all the Kaya clinics to provide the same level of standardised service is not an easy task to achieve.

Similarly, restaurants are a great business but the Dominoes Pizza model of focusing on home delivery is a lot better than Speciality Restaurants which serves people through the fine dining format because while the former is capital light the latter is capital intensive.

Grocery retailing was supposed to be a secular growth business but the steep rent and competition among the retailers coupled with the low margin nature of the business has made the model uneconomical but speciality retailing like Titan's watch and jewellery stores have survived the competition very well and despite the regulatory challenges generates a RoE of close to 30%.

PROBLEM OF FIXING PRICE POINTS:

Some small ticket FMCG products suffer from a unique problem of fixing prices in whole numbers. Assume a company selling ball point pens for ₹5 and due to cost pressure wants to increase the price by 10%. The new price at ₹5.50 creates problem of settling a transaction as when a customer pays ₹10 and wants ₹4.50 in return, the shopkeeper will have to struggle to give back the precise amount in change. This problem forces a company to keep prices in whole numbers which also means a big jump from the previous base as having the new price at ₹10 from ₹5 earlier is too big a move whereas any intermittent price change creates problems of transaction completion.

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INDIAN PHARMACEUTICAL COMPANIES ARE DIFFERENT FROM THEIR WESTERN COUNTERPARTS

Jeremy Siegel in his book 'Future for Investors' argues that over a multi year period pharmaceutical stocks have made the maximum amount of money for investors in the American markets followed by consumers and financials. Shareholders of these western pharmaceutical companies have benefitted primarily by the ability of these businesses to invent new drugs and then get them patented to earn above average rates of return for their investors. However, most of the Indian pharmaceutical names aren't the typical drug discovery powerhouses like their western counterparts. In case of pharmaceutical companies, one has to distinguish between the secular generic players like Cipla on one hand and drug discovery stories like Dr. Reddys, Ranbaxy, Lupin, Biocon and Sun Pharmaceutical on the other. If an investor does not understand the U.S drug discovery format and most don't, he should keep away from these kind of companies or else back up the large and established players only. Wockhardt was one company that moved to ₹2,100 from a low of ₹120 in 2010 and then dropped back to ₹400 as the market adjusted to its news about irregularities with regards to the U.S FDA norms.

I stay away from this sector as most Indian pharmaceutical companies appear as lottery tickets with their ANDA filings and the U.S FDA regulations which seem to come and hit any company without warning. Moreover, one has to have very strong domain knowledge to understand what is actually happening on the ground when such an event actually comes out to hit a company. Personally, I think that a) at best a group of pharmaceutical businesses can generate an annualised return of 30% which we can get from other opportunities as well and b) Warren Buffett become the richest investor in the world by ignoring pharmaceutical stocks in U.S which as a country was the mother of all research & development activities of any kind. While understanding pharmaceutical companies is complicated, pharmacy retailing is a fantastic way to play a sector where there is no risk of inventory

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BACK THE LEADERS IN THE INFORMATION TECHNOLOGY BUSINESS:

Most of the IT Services companies are mature, well researched entities where any kind of value addition by an individual investor will be negligible. *One of the first signs of a mature industry will be a lack of too much stock price volatility.* Clearly, the cement stocks in 1992, IT in 2000, real estate and infrastructure in 2008 were young industries whose stock price also reflected extreme volatility. As the industries matured the stocks became quieter and calmer. In the IT Services space, the large cap leaders have performed almost as well as the small and mid cap names so occasionally an investor might be able to spot a short term winner but in the long run its the leaders that continue to do well - just like most of the other sectors. So whether it was Visualsoft in 1999, Geometric Software in 2003, Nucleus in 2004 the smaller sized technology stocks always found it tough to compete against the larger sized companies.

When Nucleus Software was introduced to limelight in 2004, it was debated that its banking solution would take the company to great heights. The stock advanced twenty times from 2004 to 2007 and then lost 90% of its value over the next two years. The company continues to struggle since, as its product for delivering banking solutions has found it tough to penetrate into the large banks which have favoured Infosys's 'Finacle' over that of Nucleus.

Stocks from the IT space generally do well when the dollar starts to appreciate against the rupee. However, such an outperformance is usually short term in nature because ultimately companies are valued for their operating performance and not for currency gains. A gaining dollar also makes the clients sit up and renegotiate old contracts and while not all contracts go in for repricing, the depreciating currency don't add too much to the valuations and act like a one time gain to earnings only.

A depreciating currency is however good for pharmaceutical companies where the ability of the company to hold on to price gains is higher when compared to the companies in the IT Services space. Also if all countries encounter a simultaneous currency depreciation then the currency movement

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does not change the competitive dynamics of the industry as outsourcing from one country remains equally attractive when compared to getting the work done from another.

MEDIA:

Globally media is a secular growth business as most of the international media chains are completely integrated enterprises. In India though, media is represented mostly by the news broadcasters most of whom are not run with a profit motive. Under such a scenario it becomes difficult to lay a long term bet on the electronic media space and though the entertainment space is represented by Zee TV the same suffers from cut throat competition. The general sense is that once addressability or digitisation comes in, it would significantly increase the transparency of the entire sector. But most of the content distributors suffer from lack of corporate governance issues and hence it becomes a challenge in identifying the right horses to bet on. But an investor in media companies should follow the TRAI website very closely as it is the TRAI that will set the road map for addressability. When I was holding Television Eighteen I used to search the TRAI website for important developments in the industry and also attended a couple of conferences (as a consumer), that the regulatory authorities conducted to get a public and industry feedback on the sector.

The print media is a slow compounding machine and though the companies are doing well there are serious long term headwinds on the existence of the industry as such but unlike the electronic space most of the print media companies are making money for their shareholders.

VALUATIONS:

Secular growth businesses are better valued by multiplying the EPS with the P/E. There are more methods of P/E discovery than just the growth of the business as we have elaborately discussed before. Some analysts use the discounted cash flow method to analyse secular growth companies as the earnings growth profile for these companies are predictable. *While using growth to decipher the P/E for valuing these companies, one should also stress*

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on the dividend yield as companies with a high payout get their valuation on the basis of the yield also. Some more points to note on secular growth companies are:

a. They will generally be expensive when compared with stocks from other sectors and one will have to buy them with a leap of faith rather than by looking at the rear view mirror.

b. They have a long business life. In other words, once a trend picks up it continues for several years. It isn't easy to think of a Colgate or a Nestlé going out of business easily.

c. Being free, in cash flow generation and low in capital expenditure these companies generally throw back lots of cash to their shareholders as dividends.

WHAT CAUSES THE TREND TO BREAK?

Finally, in case of a secular growth company a rising price of a stock with negative cash flow and debt is more likely to see a trend break than a stock which is cash-flow positive without debt. When the trend is positive and the sector is in demand all stocks look like secular growth companies but the most essential ingredient of a secular growth company will be the nature of its cash flow profile. When retail was in demand both Pantaloon Retail and Titan Industries looked like secular growth companies but as the hype subsided it was clear that Pantaloon had grown too fast on a negative cash flow with too much debt and had to slow down, Titan on the other hand continued to grow at its own pace making it essential for investors to check on the debt and cash flow profile of a growth business before declaring whether it is a long term secular growth story or not. *Merely generating revenue growth in the backdrop of an industry tailwind does not make a company qualify for the secular growth tag. The growth should be capable of being achieved by internally generated funds also.*

Of course, there are other sector specific reasons of a trend breaking down like market saturation, changing competitive dynamics etc but if the company

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slowdown which would make it a dividend stock and hold the price even at an optically higher P/E ratio.

Generally, buying a secular growth business only for what it is worth today and not more, has caused more harm than buying the inferior ones at a discount. Surprisingly, this theory works less in a bull market and more in a bad one as everything goes up in the bull market so there is no unique scarcity premium to be put on the superior growth businesses, whereas in a bearish phase small pockets of growth attract large doses of capital which ensures that good businesses get relatively more expensive when the chips are down.

Overall, secular growth companies remain the most favoured way to generate consistent long term wealth. *The biggest advantage with these kind of companies is that the terminal values in such companies are easier to forecast and are in most cases achieved with limited margin for error.* An investor who has a long term view in the markets should therefore try and ride on these auto pilot type of companies where once a buy decision has been made the time to sell does not come anytime soon.

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Chapter 39

PORTFOLIO CONSTRUCTION STRATEGIES

No position is too big for a stock that is going up and no position is too small for a stock that is coming down.

An investor's portfolio weight is a function of his risk-profile, investment corpus, relative stock valuation, his own cash flows, time horizon and liquidity needs. *Very few people realise that having the right portfolio weights is more important than picking up the right stocks.* While all investors remain focused on what to buy and an even more keep looking for when to buy, very few actually ponder over the question of how much to buy. *With age, experience and maturity an investor realises that making money from the market is not the same as making wealth. While buying the right stocks at the right time will make money for an investor buying those stocks in the right proportion will make wealth for him.*

Strangely for most investors, the joy of seeing a stock go up isn't related to its weight in the portfolio! Portfolio construction therefore deals with the aspect of buying the right stocks in the right proportion. Large wealth creating opportunities don't come too often to an investor and when they do they should have the power to make a difference to his balance sheet. An opportunity that has the power to change the balance sheet should not only go up in price but also be capable of being bet big. *An investor who makes a hundred fold gain from an investment where he had a 1% allocation just manages to double his portfolio while a hundred fold rise from a 20% allocation takes the portfolio up twenty times. A small allocation with a large gain is only as good as a small gain on a large allocation. What really matters though is achieving a large gain on a large allocation.*

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DIVERSIFICATION VS. CONCENTRATION:

I learnt the art of betting big very early, more by default than by design. With limited investment corpus and a desire to make large gains, the resultant effect on the portfolio was few bets with large positions rather than many bets with small positions.

When my portfolio grew in size I realised that betting on a few names helps in two ways. Firstly, it reduces the chance of making wrong investments. An investor betting on a handful of stocks is more likely to avoid Suzlon, GMR, Arshiya and Manappuram rather than an investor who has a large diversified portfolio of stocks. He is also more likely to retain ownership in Infosys than in Satyam, L&T than in HCC, Page Industries than in Lovable, Titan than in Gitanjali. He succeeds in eliminating the losers more by the process of elimination as much by his skills of identification. On the contrary, having a widely diversified portfolio dilutes the large winners for the poor losers. The weight of Infosys, L&T, Page and Titan will get reduced for the losers like Satyam, Hindustan Construction, Lovable and Gitanjali. The dilution of winning bets in a focused portfolio happens by the desire to add more stocks rather than by the strategy to focus on just a few right ones.

Secondly, when an investor takes a few large bets he is always focused on comparing the relative opportunity of holding one stock with respect to another as having a concentrated portfolio compels him to focus more on risk management. An investor who has a large allocation to a certain stock will bail out on the first sign of trouble when compared to another investor who has a smaller allocation to the stock. With a large allocation there is no second chance and hence risk management will ensure that the investor not only chooses the best bets but also moves out of them on the first sign of trouble. *This is because the concentrated portfolio investors realise that the stock market is not the place to be brave as no martyr collects the gallantry award himself.*

Critics argue that this strategy of making large sized bets works both ways. A smaller allocation saves the investor in times of a downside whereas a larger allocation in a wrong stock runs the risk of setting him back by a few years. Well, if a smaller allocation does not matter either way then why have

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it in the first place? It is difficult to have the eleventh best idea work better than the fifth and even if it does, the diluted weight of the eleventh idea will work against the portfolio moving too much because of it.

WHEN DOES PORTFOLIO DIVERSIFICATION HELP?

Though there are no rules in this game portfolio diversification helps if an investor gets it wrong and hurts if he gets it right. An investor who owns a diversified set of stocks will generally be risk averse and to some extent unsure of the stocks that he owns when compared to an investor who owns fewer businesses. Additionally, having a diversified set of companies will also lower the average quality of the business as subsequent bets would be of an inferior grade when compared to the initial ones.

Having a diversified set of stocks also cuts down the volatility of the portfolio with a higher level of excitement and involvement as some stock will always be moving up or coming down. This will keep the investor interested and busy for results and other company events. On the other hand, having a lesser number of stocks makes life a bit boring at times with less fun and action.

The fund manager enjoys an enhanced probability to catch a multibagger from a portfolio of forty six stocks than he would from a set of six but irrespective of the weight, the winning stock serves as a great marketing tool for prospective clients in investor presentations and conference calls. This is because most clients are generally interested in knowing the winning bets of their fund managers rather than how much the winning bet contributed to the overall fund performance. In a nutshell, portfolio diversification is for protecting capital, while concentration is for growing it.

PERILS OF PORTFOLIO CONCENTRATION:

Most funds stay away from holding concentrated portfolios as it is difficult to deploy a large corpus in a few names as the fund might not be able to liquidate the entire holding at short notice in case of urgent redemption pressure. These redemption requests come mostly towards market bottoms where liquidating holdings become more difficult as volumes and participation

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generally dry up towards the lows. Concentrated portfolios because of the sector and stock biases can also underperform the broad indices in the short term and hence pose a problem to open ended funds who cannot tolerate a Net Asset Value (NAV) underperformance even in the very short term.

Even though diversification allows the dilution of good stocks with the bad the compulsions of holding a diversified portfolio for large funds does not extend to individual investors. These investors can take a focused portfolio approach to maximise returns as an individual investor unlike his institutional counterpart faces no NAV pressure, can handle the interim fluctuation and is not likely to bail out at market bottoms - hopefully.

Portfolio allocation should always supersede investment opportunity. Investors who receive stock options from the companies they work in invariably find themselves in a situation where the value of such options exceeds 80% or more of their net worth. Unless the portfolio is too small or the investor is himself a promoter, it is a risk to be aggressively betting on one company no matter what the opportunity looks like. Irrespective of the opportunity at hand, such a portfolio allocation isn't desirable from the risk management point of view as it can inflict serious damage in case of an unknown adverse scenario. Even though the probability of such an event is remote no one wants to be in a situation where his company heads into a permanent economic challenge where he loses his job on one side and sees the stock go down on another.

It is important to retain the balance even in a concentrated portfolio because too much of concentration is another word for greed.

MANAGING SWINGS IN PORTFOLIO WEIGHTS:

If a portfolio has been constructed then there will be instances when one stock undergoes a disproportionate fall in price. Under such a scenario, the holder of a concentrated portfolio should not rush in to buy whereas a holder of a diversified portfolio can eagerly look forward to taking advantage of such price declines. *There can't be anything worse for an investor holding a few stocks than to average a losing trade.*

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When an investor holds a few stocks, there should be zero margin for error and he should be prepared to take a 180 degree turn on his investments so if he was bullish on a stock in July and intended to hold it for 5 years then there is nothing that should change his mind into selling the entire thing in August if the fundamentals move against him. When an investor owns just five to six names he cannot give the market a second chance. Personally, I prefer to move out at the first stroke of trouble even if it comes with the cost of losing the potential upside rather than expose the portfolio to downside risks.

On the other hand, if a stock in a concentrated portfolio moves up too fast the investor should not look at ways to reduce exposure by trimming down on every rise. A stock that has a 40% weight in a three stock portfolio and moves up to 46% because of temporary outperformance should invite attention to trimming down its exposure back to 40% of the current value only. In case the weight moved to 24% from 20% in a six stock portfolio the investor should sell a little slowly than what he would had it been a three stock portfolio. Investors with diversified portfolios consisting of 10 or more stocks should however be very lazy when it comes to trimming down on a winning position.

SIZE OF THE PORTFOLIO AFFECTS DECISION MAKING:

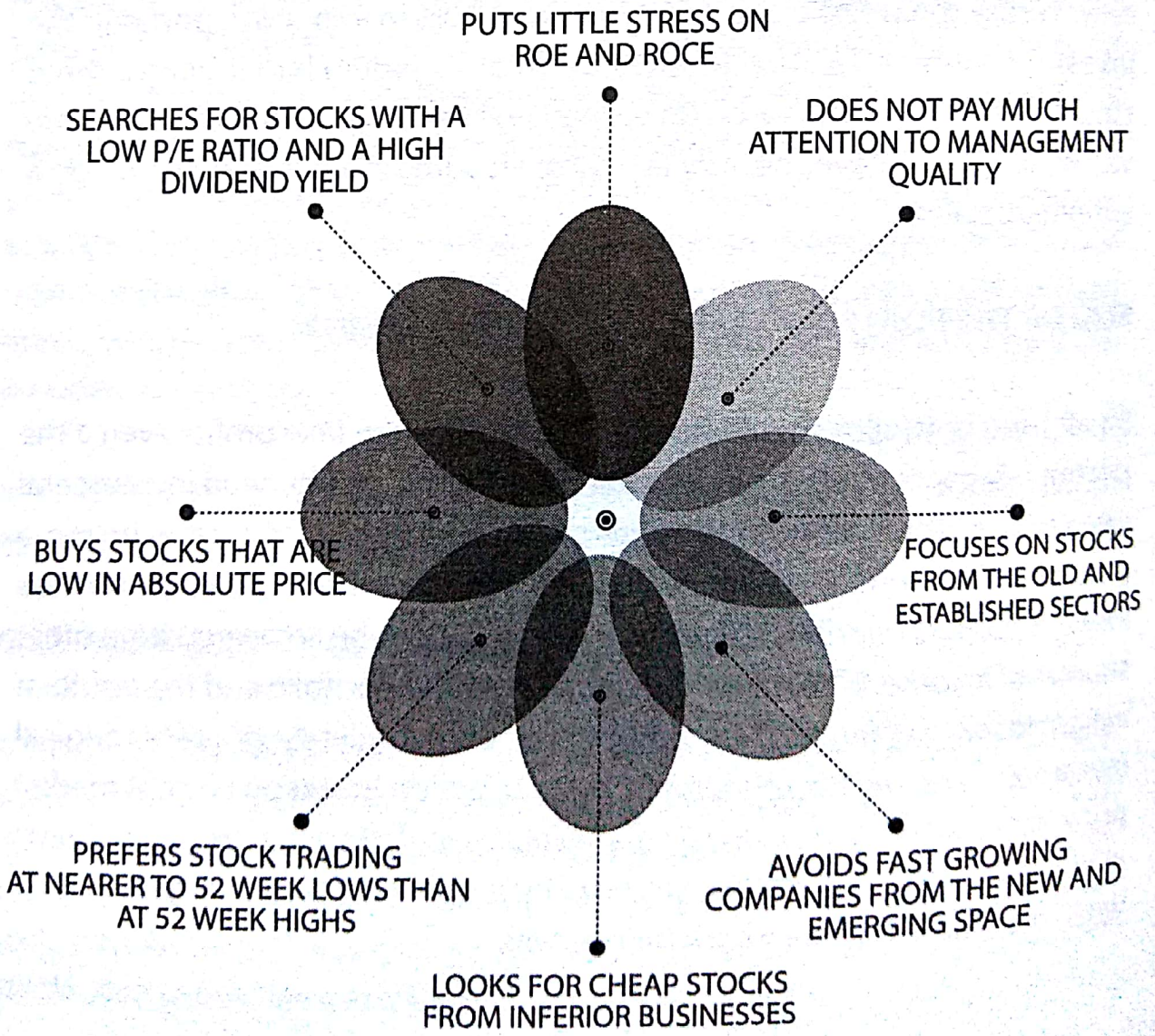
Small sized portfolios should however be reluctant to take profits even if the portfolio is concentrated, however larger portfolios might need incremental tweaking as the potential damage could be more. In this case, losing a portfolio of ₹5 crores by taking higher risks can cause irreparable loss whereas losing a portfolio worth ₹5 lacs causes a loss that can be recovered from other sources of income. While computing the size of the portfolio and the resultant weight for each of the stocks, an investor should completely ignore his original investment and decide the future course of action based on current market price only. *The reliance on the invested capital and the purchase price of each of his stocks will be in direct proportion to his inability to take the correct decision when the time to take such a decision arrives.*

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PORTFOLIO CONSTRUCTION FOR THE FIRST TIME INVESTOR:

A majority of first time investors run the risk of losing their initial capital not because they pick the losers but more because of their inability to stick to the winners. The new investor should therefore focus only on established blue chip names as part of the portfolio construction process. A few names that come to mind for the inexperienced new investor are Asian Paints, Nestle, ITC, HDFC Bank, HDFC, Sundaram Finance, Cipla, TCS, Sun Pharmaceuticals and Bajaj Auto. However, as the new investor with a limited corpus is generally in a hurry to grow his portfolio he would be more reckless in the process of portfolio construction as he tries to fill his portfolio with stocks that have the following attributes:

A NEW INVESTOR GENERALLY



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a) Based out of inferior business models as the ones with a stronger business model would trade expensive.

b) Focussed on asset plays than on company growth.

c) Mostly from mature or saturated sectors rather than from new and emerging themes.

d) Little focus on evaluating the management.

e) Low in absolute price, for example a new investor would love a stock that trades at ₹30 than at ₹330.

f) Low on the PE ratio.

g) High on dividend yield.

h) Having low price to book and moderate RoEs and RoCEs.

i) Trading near 52 week lows rather than at 52 week highs.

j) Second, third or even the fourth largest player in the industry as the leaders would be costly.

Most of these stocks would be recommended by friends, relatives or even the broker and while the investor would put maximum effort on stock selection their allocation to the portfolio will be random and abrupt.

A small investor who can avoid stocks that confirm to the above criteria is more likely to become a large investor.

However, the new investor always finds reasons to lose his first investment. He will argue for more risky bets just because his portfolio is small. Most first time investors are not happy making just above average returns as their target remains on creating a retirement fund out of the first few months of investment, an ambition that puts the entire portfolio to risk. A better way to adapt an aggressive posture is to slightly leverage the portfolio and stick to high quality companies. *A small first time investor should not indulge in small cap investing unless he can understand the various facets of investing and the fact that he has started new is enough proof that he does not. For a new investor with a definite stream of future cash inflows, staying slightly leveraged in high quality businesses is relatively better than being invested without leverage in inferior quality businesses.*

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A key ingredient of the investment process of the first time investor is to rely on the established names and avoid looking for the emerging blue chips, the turnarounds and the cyclicals. The option of betting on unknown names should be limited to a small weight of the portfolio. Even while looking for the unknown names the new investor would do well to stick to the sector leaders with high RoEs and a growing yield.

CONCENTRATION IS ONLY FOR THE INFORMED:

As an investor matures, he understands the nitty gritty of the market and learns the skill to look beyond the financial numbers. With experience he acquires the ability to create a mental framework of business models which helps him in predicting the future rather than researching the past. If he has been successful he will also generate his own preferences which would revolve around a set of industries that he thinks are within his scope of understanding. Slowly his portfolio construction strategies will start to be defined by his level of success. *Personally, I have made all my money owning less than six companies so the idea of making money by owning sixty stocks might look bizarre to me, alternatively a person who has made money owning sixty stocks might not be comfortable owning six but after an investor learns to understand the market he can think of consolidating his investments into fewer names.* Having a concentrated portfolio approach can be disastrous but the rewards far outweigh the risks if followed with care and caution.

An individual does not need forty good ideas to work for him, he just needs six to eight great ones, an option which is always available irrespective of the market. If one can't get seven good ideas out of seven thousand listed stocks then it becomes a game not worth playing at all. No one gets rich by having his thirty ninth best idea work better than what he thought it to be but having the fifth best idea work as per plan has made several investors far more wealthy than they would have bargained for. Conversely no one gets poor by having the thirty ninth best idea work against plan but several investors have had to bite the dust when their fifth best idea went against them.

Many investors think that owning a diversified portfolio means having a large number of stocks. The focus for deciphering whether a portfolio is focused or diversified should not be on the number of stocks but on the weight that

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these stocks have. A portfolio with seventeen stocks where the top two say Infosys and SBI constitute 58% and 20% of the portfolio with the balance 22% spread out among the other fifteen stocks is as concentrated as a portfolio which is spread out equally among three stocks.

CONCENTRATED PORTFOLIO	
Company	Weights
Infosys	58%
SBI	20%
Other 15 stocks	22%
Total	100%

The above scenario is very common with a lot of people who earn ESOPs which skews the portfolio weight in favour of the company where they work. In this portfolio, if SBI goes down and Infosys cannot contribute much then it would need all the other 15 stocks to perform in order to make good the loss from SBI. Similarly, if Infosys goes down then it would need everything else to set the equation right. However, getting sixteen right decisions for one wrong one is not an easy task to achieve.

AN INVESTOR WITH A CONCENTRATED PORTFOLIO CANNOT AFFORD TO LOSE:

An investor who focuses on building a concentrated holding of stocks has to disassociate himself from several profitable investment opportunities because of risk control measures. He cannot afford to be betting big on the turnarounds from the textile sector or on a company that has no earnings but is expected to do well in future. The only way to approach a company with no performance and only promise is to buy a little which goes against the rules of concentration as a small position will not make a difference on the returns and a large one is not worth betting on, in terms of the associated risks that it brings along. *Following a concentrated investment approach will thus create a string of misses for the investor as his focus on avoiding the losers will discourage him from buying a stock which he would have otherwise bought as part of his diversified portfolio.*

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THE 3 YEAR - 50% TEST:

The best way to make a lot of money from the market is to avoid the losers and one way of doing that is to put a stock on a '3 year 50% test'. As part of this test each investor should ask himself whether an investment idea that he owns or is planning to own can sell at a price 50% lower to the current price 3 years down the line. So even if a stock is expensive an investor will get an immediate answer on this based on the management, business model, growth profile and past operating history. Consider a stock like HDFC Bank trading at a price of ₹630 to its Fy 2014 EPS of ₹35 which gives it a P/E of 18 times. Now if earnings double up in 3 years and the stock falls to half the current price it would mean that the stock at ₹315 would trade at a P/E of 4.5 to its Fy 2017 EPS of ₹70 which appears bizarre.

An investor can argue whether the company will grow at 25% for 3 years but the above analysis builds in a significant margin of safety which makes the chance of losing capital quite remote. Even if earnings do not grow at 25% the stock might trade at a higher PE so the safety cushions are inbuilt as the various errors of forecasting will cancel each other out.

CREATING THE PORTFOLIO:

As markets run on themes one way of consistently outperforming the averages is by being on the lookout for new emerging themes. An opportunistic investor should therefore identify the top two or three sectors or themes and then pick up the best stocks from the theme in vogue. The selection process could be elaborate and revolve around the management, business model and valuations but an investor who isn't flexible in his investment strategy will find it difficult to consistently generate above average returns from the market. *The investment style of putting money behind the 'beaten down names' or the 'Dogs of the Dow' is fine but there is always some more money to be made by buying stocks that have a favourable tailwind behind them.*

Once an investor has filled 50% to 60% of his portfolio with stocks that are doing well because of a favourable economic set up he can then look to fill the remaining part of the portfolio with the 'out of favour' stocks. While

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buying stocks that are in favour, the investor should pay attention to valuations and other associated parameters rather than just buy the trend. It is generally more profitable to buy companies which are seeing a decent revenue growth and are on improving fundamentals rather than companies that are struggling to get around an economic slump. Special situations and opportunities like take-over, arbitrage and private placements should form a small part of the portfolio whereas the average portfolio should preferably be dominated with secular growth companies.

Investors who look to buy the sector in favour should have a keen eye to check for the first signs of turnaround and buy on confirmation as it is better to be a little late for a good party than be early for a bad one.

An investor should ensure that not more than 30% of the portfolio is in illiquid stocks which may be defined as one where an investor's holding is less than half of the three month average daily volumes. In case of stable, secular growth, dividend paying companies the restriction on illiquidity can be tweaked if the company under consideration is generating a reasonable yield as dividend is the best protection against illiquidity. *Liquidity should be viewed as a function of the portfolio size and not in relation to the absolute daily traded volumes.*

An investor with a small portfolio or an astute experienced investor who understands the company that he owns should not have liquidity restrictions as the big money is made buying unpopular stocks and illiquidity is one of the most powerful indicators of unpopularity.

DESIGNING A DIVERSIFIED PORTFOLIO:

A diversified risk averse portfolio should however have a certain set of checks and balances which may include:

a) Spreading the portfolio across a minimum of four sectors out of which at least two should be in secular growth mode (consumer, pharmaceuticals, IT Services and two wheelers).

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b) Keeping individual industry or sector exposure to 40% of the portfolio.

c) Restricting stock exposure to 1.75 times the average which means that if there are 10 stocks in the portfolio then no stock should exceed 1.75 x (100%/10) = 17.5% of the portfolio. If a stock runs up then an investor should trim down the portfolio to get it back to the desired allocation though the urge to trim should be relatively less in a diversified portfolio.

d) Dividing the portfolio between stocks that are supposed to grow at a healthy rate and also stocks that pay a decent dividend so that the average yield of the portfolio remains around 1.25%, most of the time. Having strong yield stocks will protect the investor in times of a market decline and also save him from getting overexposed to high valuation companies as valuation and yield run inversely to each other.

An investor in a concentrated portfolio approach should have no such investment restrictions and should continue to deploy funds depending on individual opportunities. But in spite of his knowledge on the sector the investor should have at least four stocks while restricting stock exposure to 1.5 times the average and not 1.75 times, as explained above. So in a four stock portfolio the maximum exposure of a stock should be 1.5 x (100%/4) = 37.5%.

WHEN AND HOW TO BUY?

An investor's process of stock discovery does not stop with the identification of an investment idea and depending on his risk profile he should buy an initial quantity and then follow the stock from there. Personally, I don't wait for a 10% to 15% correction to buy a stock if the story seems good to hold for the long term. I have bought stocks like Hawkins Cooker after they have doubled in price and then made several times from my purchase price and I have also lost 60% on a stock like Voltas even though I had bought them after it had tumbled 30% from its highs.

Buying low does not guarantee success as much as people think it to be. If a stock is to move up it will do so without dropping in price so as to let a potential investor

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in and if a stock is to come down it will not move up to let the struggling investor out. In most cases, it makes sense to buy a good business at the market price rather than a bad one at a discount.

If the stock acts right both in price and fundamentals then an investor should not hesitate to buy more of the same thing. In this quest, his final allocation to a stock will always been a lot more than what he had originally envisaged. The enhanced allocation happens because first a stock that appreciates in price increases in weight and secondly an investor seeks to add more to a winning idea. If the investment is in a small cap or a not so popular mid cap then he should be more comfortable buying an initial allocation at the current price and then wait for the stock to deliver better earnings growth to add more. I bought Hawkins Cooker this way. The stock had nearly doubled in a few months from ₹200 to ₹350 before I bought my initial quantity and then as the stock moved past ₹400 and beyond I added more to my position. In fact, all my purchases are repeated by buying more at higher prices just as the story gets more certain.

With Page Industries my first purchase was at ₹350 and have bought it at various levels as the stock moved up backed by earnings. My last purchase for Page is at ₹5,180. I personally suffer from no anchoring bias and in fact do not even compute the average cost for a stock in my portfolio as that is a job left for my Chartered Accountant. *To me, the purchase price becomes irrelevant the moment a trade is executed.* Investors who think too much about the purchase price find it difficult to let go of an idea if the price drops below their cost in the backdrop of deteriorating fundamentals and hence, it makes sense for an investor not to focus on their cost price as all decisions should be taken with respect to current prices when viewed in line with current earnings.

There is nothing more comforting for a buyer than to see a new high for a stock in the backdrop of increased earnings. Buying more of the same stock might seem a defective strategy to the hardcore value guy who might argue against paying more for a stock that has just been bought a few months earlier. However, an investor who buys small caps does so to make a longer haul and not just a 20% gain so it is a good idea to let the market validate his initial fundamental hypothesis by taking the stock up. An investor should

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however not be buying more of a stock after the price has fallen from his initial purchase price unless he is very sure of the business fundamentals.

The thesis of buying on a reaction to a new high should not be followed when an investor is looking to buy blue chips. A stock like HDFC Bank needs no market validation for further buying and an investor should try and buy as much as possible on a downward price correction. In case of long term secular growth companies, the ideal strategy is to buy at a price point which is 20% lower than the recent peak and while it might not be possible to buy at a predetermined price point an investor should look to buy as the stock retraces 10% from the highs. He can further keep adding to this position in every fall thereafter. This strategy of buying at a certain percentage lower down from the high is a nice strategy for an investor to use in buying a stock that is already making new highs and is set to go up further.

THE OLD IDEAS WORK FINE MOST OF THE TIME:

Overall, investors should spend at least some time in designing a portfolio structure as most investors remain focused on looking for the next stock to own rather than on how much to allocate. The only cost of investing is opportunity cost. So, if Company A is doing well and someone whispers to an investor about the prospects of Company B then he should try and compare Company B with Company A before committing new money to Company B. The best stock to own could, in most times, be the stock that an investor already owns. Imagine an early investor in Wipro who having bought the stock in 1980 looked to exchange his stock for something new in 1981. A ₹10,000 investment in Wipro in the year 1980 would have grown to over ₹500 crores today had an investor just stayed with the old.

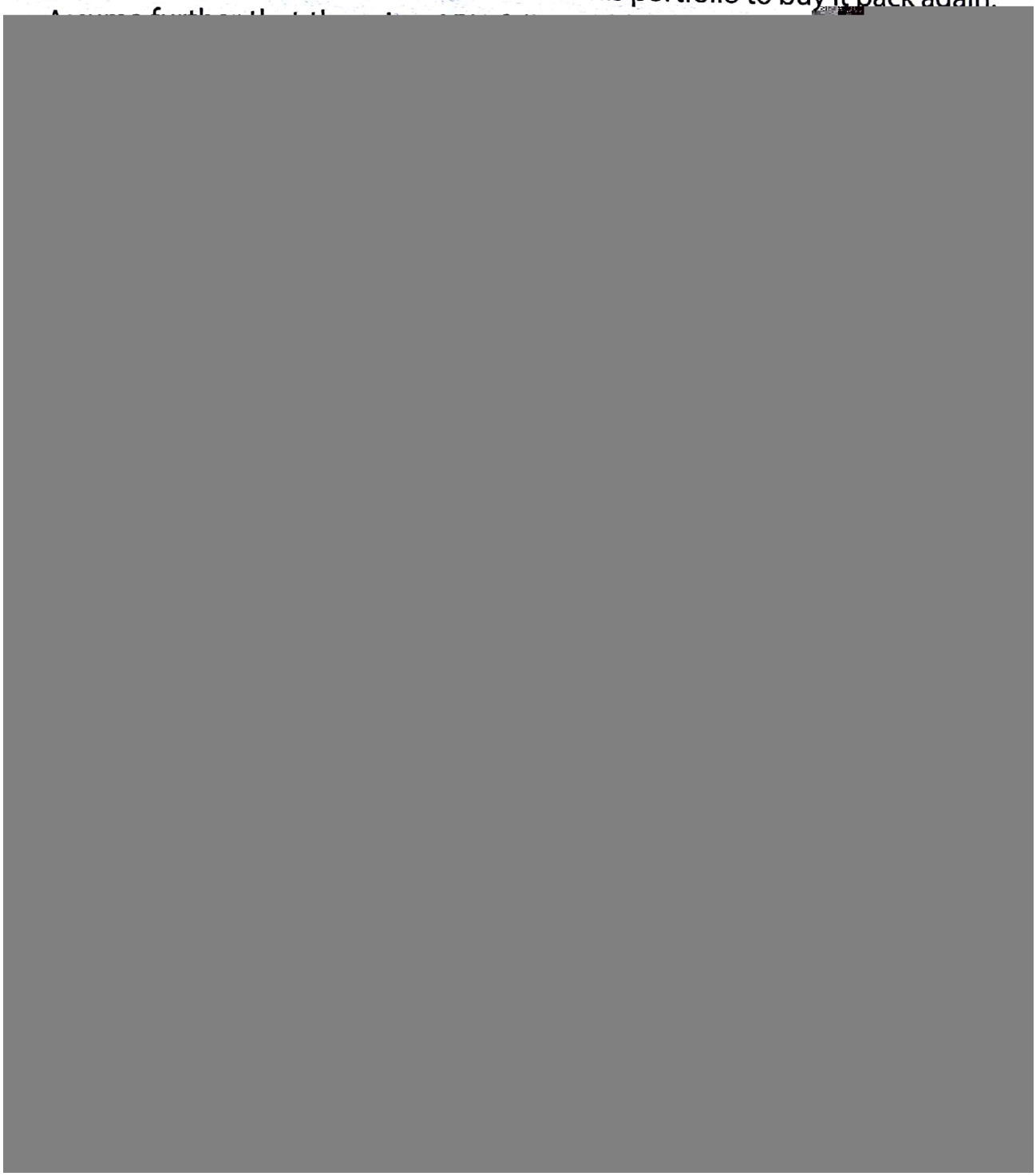
SWITCHING STOCKS FOR CASH AND THEN BACK TO STOCKS AGAIN:

Once an investor has set up his portfolio there is very little to do except to wait for the story to unfold. Investing as a full time job is dull and boring and it takes a lot of belief and conviction to sit tight and do nothing while the rest of the world is engaged in frantic buying and selling of shares each day. *Too much of activity will only make the broker rich and the art of accumulating wealth is dependent on the investor's ability to patiently wait for the terminal*

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value rather than selling a stock to buy it back on every 10% to 15% drawdown. An investor does not get rich by selling a stock which has gone up just to buy it again if it slips back. While an investor can do this for a couple of times this strategy will backfire as ultimately he would miss buying back a good stock once it moves beyond his last selling price as not everyone has the courage and wisdom to buy a stock at a price higher to what it was when he last sold it.

Let us assume an investor who sells 25% of his portfolio to buy it back again.



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the size of opportunity. It is such an educated guesswork that helps an investor make large sized gains from large sized bets. As on date, sectors such as consumers, mortgages, private banks and pharmaceuticals provide that kind of a terminal value expansion and a portfolio which has a decent allocation to the leaders from these sectors should do really well over the next few years.

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Chapter 40

WHEN AND HOW TO LEVERAGE AND WHEN NOT TO?

A leveraged portfolio in a falling market is like a hand grenade with its pin pulled out.

Leveraging remains a risky but essential approach to investing. It is risky because it magnifies the risk of investing and it is essential because small portfolios investing in high quality, secular growth companies can increase returns by taking loan against shares. Sometimes, the opportunity at hand might be too lucrative to let go till the investor has accumulated enough of his own money to put to work. There are some essentials about leveraging but generally it is a reasonable strategy to borrow and invest up to a certain level of portfolio value in companies where an investor is more or less sure about capital protection. *Critics of leveraging should ponder over the fact that if a person can buy his car, home, television, refrigerator or even a vacation with borrowed money why can't he look at the opportunity of buying his investments on loan?*

During a bull market, an investor who is fully exposed to stocks can use borrowed money to apply for new issue IPOs and sell them on listing to make a quick gain. He can also participate in company buybacks where the price at which the company buys back its shares is generally 3% to 5% higher than the market price of the stock. Sometimes, the offer for sale of private companies or a follow on public offer from government companies also provides a decent flipping opportunity to an investor who is on the lookout for such options with an open mind. However, taking a loan for buying shares is suitable only for people who are fully invested in equities. An investor can't be earning a 8% interest on his bank fixed deposit and paying a 12% interest on an overdraft limit from the same bank.

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HOW MUCH TO LEVERAGE?

Most leveraged investors (including me) are compulsively leveraged. The sheer passion of investing makes them feel incomplete unless they have put a little more on the table than what they have. Our investment bets are ultimately as much about making returns as they are about living and sleeping well. *As Jesse Livermore said 'If your stocks are keeping you awake at night then sell down to the sleeping point' but for me if my stocks keep me relaxed during the day I leverage myself up to the worrying point.* Leverage should however, come with a lot of primary (real) research and can't be dependent on hearsay recommendations from television analysts, internet forums, chat sites and brokerage reports, many of which are run by people with vested interests and questionable integrity.

Leveraging is advisable only if the investor has alternate avenues of income and he is on the whole generating a surplus cash flow. The alternative source of income is essential so that an investor does not have to sell his shares off to repay back the loan. The quantum of leverage should therefore be limited to the lower of either:

a) 20% of the post leveraged portfolio value

b) The amount of surplus which the investor can generate from his alternate sources of income over a period of eighteen months from the date of loan.

To elucidate the above argument consider an investor with a portfolio of ₹10 lacs. A 20% loan on the post leveraged portfolio would work out to ₹2.5 lacs which is 20% of ₹12.5 lacs (₹10 lacs + ₹2.5 lacs). Now if the investor's alternate sources of income can over a period of eighteen months generate ₹2 lacs then the investor should borrow only ₹2 lacs and not ₹2.5 lacs for augmenting his returns under leverage.

Additionally, if an investor restricts leverage at 10% of the portfolio he would remain unperturbed about servicing the interest component of the loan. Assuming a portfolio yield of 1.5% the yield on a hypothetically leveraged ₹10,00,000 portfolio would work out to ₹15,000. Now, if the leveraged component of this portfolio is ₹100,000 than the dividend income of ₹15,000

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would work out to 15% of the loan value, in which case the investor will not have to frequently sell off his shares to service the interest component of the loan.

WHY IS LOAN AGAINST SHARES BETTER THAN AN OPEN DERIVATIVES POSITION?

Many investors try and take out leveraged positions by buying stock futures from the derivatives market. Taking leveraged positions through the derivatives market comes with a few drawbacks and isn't as cost efficient as buying shares on loan because of the following reasons:

Firstly, shares in the futures market generally sell at a premium to the market because of the inbuilt cost of carry. This cost of carry fluctuates between 12% to 18% on an annualised basis depending on the overall market mood making the cost of holding derivatives position almost as much as the interest that an investor pays on borrowed capital.

Secondly, derivative positions have a cost of rollover which creates an additional monthly charge for an investor as he rolls over a position from one month to the next. Along with the brokerage there is a cost of spread which has to be incurred each time the shares are put up for a switch to the next month.

Thirdly, a derivatives position results in a daily adjustment for mark to market margin (MTM). The practice of recovery of MTM on a daily basis disturbs the investor's long term view and compels him to shut out the position at precisely the wrong moments, which are in most instances the turning points.

Fourthly, a derivative position makes an investor reckless. He overestimates his paying capacity while underestimating the risks of investing. The propensity to quickly raise the derivative position without adequate risk management has been the downfall of many smart investors. On the other hand, when an investor buys shares on loan and for delivery the process of investing does not remain as active and volatile as it does when he is running a derivatives position.

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WHICH STOCKS TO LEVERAGE ON?

Investors should leverage their portfolio under very specific situations with very special stocks. For the purpose of leverage, a portfolio consisting of inferior stocks with an uncertain future will be considered suicidal when compared to another portfolio consisting of secular growth compounding machines. *A leveraged portfolio starts to hurt the moment stocks start to make a downmove hence an investor buying shares on borrowed capital should first ascertain the character of the stocks in the portfolio. Leveraging is not suited for an investor who is desirous of betting on cyclical turnarounds, illiquid small caps that are not the leaders of their industry or stocks which have no yield protection.* A leveraged portfolio thus needs a set of stocks that are stable in growth profile, generate healthy cash flows with high RoEs and RoCE and sport a rising dividend yield. Here, it does not make too much of an economic sense to leverage a portfolio to buy a 15% to 18% grower like a Nestlé or an ITC as the cost of debt at around 13% should be used to at least generate a return of around 25% to 26% otherwise the risk reward trade-off isn't worth betting on.

As most lending agencies advance loans only against a specified list of stocks many investors focus on buying only those stocks that are part of this specified list. Buying shares just because they are on the bank's approved list isn't a smart portfolio construction strategy. Shares should be bought because the investor believes in the story and not because they have been nominated to be taken as collateral security by lending agencies. *Surprisingly, most of the potential multibaggers don't enter the bank's approved list unless they have gone up a few times.*

The idea of introducing leverage in a stable portfolio is to remove the uncertainty element from an unleveraged, unstable portfolio and yet generate the same or in most cases a higher return. Predictability of earnings with a rising yield forms the cornerstone of a leveraged portfolio and investors who intend to enhance and magnify returns through leverage should understand that having a leveraged portfolio would also mean that they let go of several money making opportunities for surer things. *A leveraged investor should bet on surety and certainty from a stable and strong set of stocks rather than be lured by the higher returns from an inferior set of businesses. Leveraging a portfolio filled with an inferior set of businesses is a sure shot recipe for disaster.*

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It isn't essential for all the portfolio stocks to be of necessarily a very high quality but a portfolio where the value of superior quality stocks exceeds seventy percent in terms of current value is more suitable for leverage than a portfolio where stocks with highly predictable earnings are in a sheer minority.

A LEVERAGE WORKS BOTH WAYS AND MORE OFTEN THE OTHER WAY:

There are numerous examples of investors who blew themselves up because of leverage but the underlying reason for all those blow ups was not the use of leverage but the use of 'excessive leverage'.

The difference between the use of 'leverage' and 'excessive leverage' is significant. Excessive leverage brings forth solvency issues where the fall in the value of shares puts the entire portfolio at liquidation risk by the financier and liquidation almost invariably happens at market bottoms, at prices which are created more by the desperation to sell rather than by the fundamental attribute of the company whose share is being put up for sale.

Excessive leverage cuts both ways. If it works well, it can change the overall wealth equation of an investor but if it doesn't and more often it does not, it runs the risk of causing serious damage to the portfolio. I used the 'excessive leverage' route during the early part of the last decade where I was borrowing to the hilt and investing the money in a group of stocks that were acting right. My borrowings rose periodically because as the value of the portfolio rose my financiers allowed me to borrow more. It was a classic case of leveraging in an infinite loop where the incremental increase in borrowing power forced me to buy more shares which was subsequently pledged to the lending agency to borrow more.

The process of leveraging to the hilt worked for me because the underlying stocks that I had bought were moving up multifold. There cannot be anything better for a portfolio of stocks that is leveraged on the way up and there cannot be anything worse for a portfolio that is leveraged, on the way down.

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Price and not valuation influences an investor's decision to go on leverage that's why leverage thrives with the bull and shrinks with the bear. When my portfolio continued to grow, I took leverage as an integral part of my investment process. At the market peak in January 2008, the leverage component was only 9% of the portfolio as I had tried managing the risk through these self created filters. *Another problem with leverage is that it is easier to know when to hold them, but far more difficult to understand when to fold them. Investing with leverage becomes easier when stock prices rise in value as the investor has to do nothing but maintain status quo.* However, if stock prices were to suddenly fall, the investor would need to break away from the status quo and sell so that leverage as a percentage of portfolio does not increase but remains in check. When stocks fall in value, the percentage of leverage rises very fast as the loan value stays constant even as the portfolio value keeps shrinking. Selling stocks especially on the way down is one of the most difficult things to do as the investor remains caught up in a price anchoring bias which forces him not to sell at any price below what he has seen the day before!

As the market dropped in 2008, I continued to suffer from the same psychological challenges. Each day brought in lower prices as I continued to struggle against selling on falling prices. Though the absolute value of leverage did not change, the percentage of the portfolio on leverage rose dramatically because of the overall market decline. From 9% in January 2008, the leverage component of the portfolio jumped to 30% by October 2008 because of a near 70% drop in the portfolio value, as I failed to reduce the leverage component of portfolio in line with falling stock prices. *The propensity of an investor to increase the leverage with a rise in portfolio value will exceed his attempt at reducing the leverage with a fall in the portfolio value, an action that forms an essential part of risk management.*

In my case, I finally reduced my leverage in the first week of October 2008 more out of fear than out of any intention to manage risk. It was then that I realised that the risk of investing on leverage does not arise from the cost of servicing the debt from interest payments but from the risk of an overall fall in the

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who is sitting on borrowed capital cannot afford to follow the practice of holding on to his position as falling stock prices need to be countered either by selling shares or repaying the loan so as to keep the percentage of loan under check at all times. This is the reason why investors who leverage their portfolio should do so only to the extent of near term surplus cash generation. If in the midst of the investment phase the market enters a vicious downward cycle, the investor should be ready to reduce the leverage component to manageable levels either by introducing new cash or by selling some of the shares to repay the loan even if the sale has to be effected at prices lower than his purchase cost.

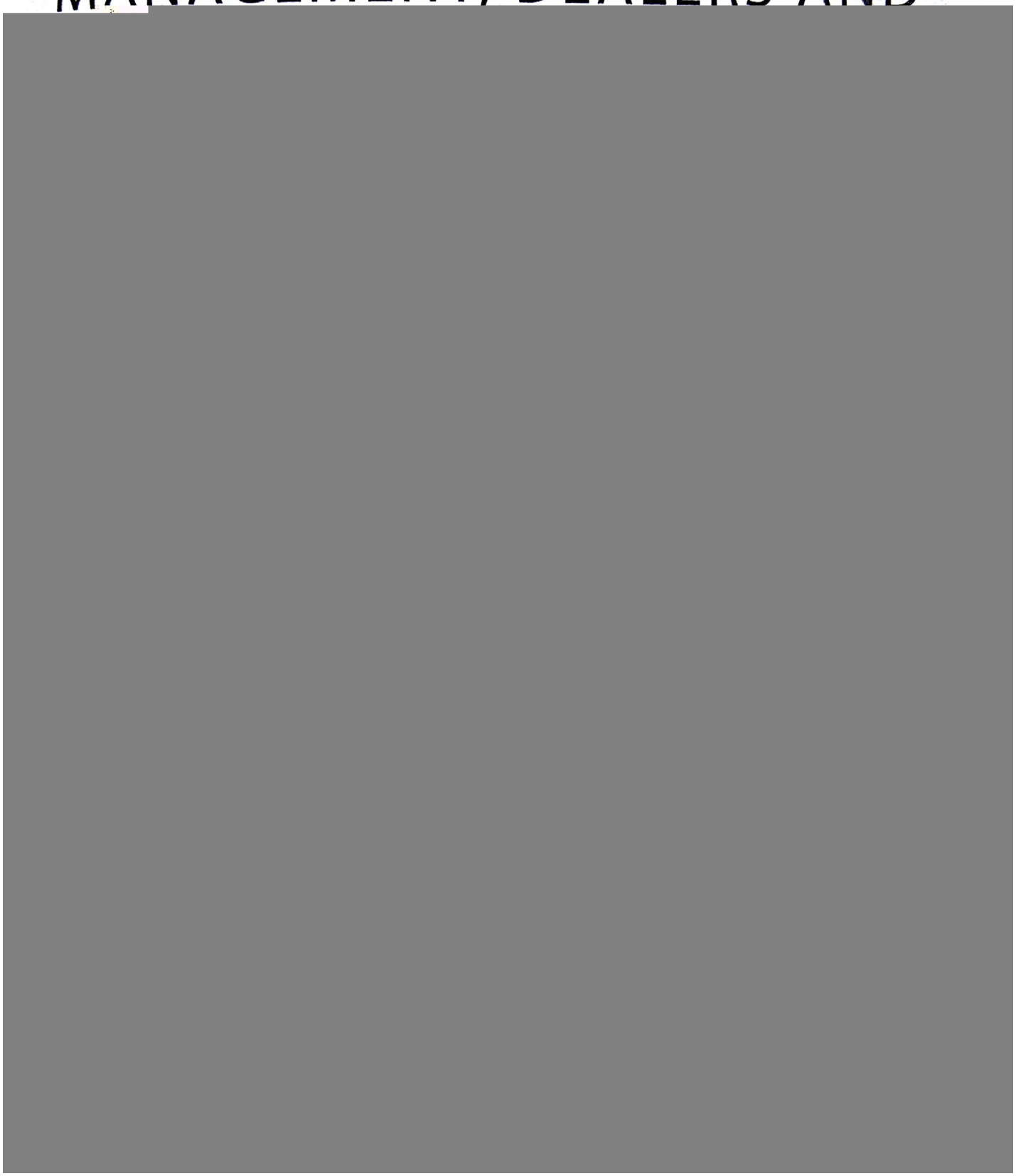
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“Stocks which make the biggest moves don't move in sync with the overall market. Their big advances come on quieter days!”

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Chapter 41

THE FINAL CHECKLIST: CONTACTING COMPANY MANAGEMENT, DEALERS AND



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FOLLOW THE COMPETITOR:

In this context an investor can follow the competitor, an investor in Gujarat Ambuja Cement should read about ACC, if he holds Colgate then he should understand how the toothpaste division of HUL is performing, a holder of Exide should study the results of Amara Raja Batteries. As most companies do conference calls with analysts and shareholders, the transcripts are generally uploaded on their websites which can be used by investors to advance their knowledge on a particular industry or a competing company of that sector. These transcripts provide important feeback on the nature of the industry, the growth dynamics and the competitive challenges affecting the overall business environment. The business environment remains same for every company so the information that the management of ACC would provide on the cement industry can in most cases be used by the holders of any other cement company quite easily.

It is always a good idea to quiz a management to obtain feedback on the same from its competitor. If Exide talks positively about Amara Raja it is ten times more significant than an analyst talking about Amara Raja and twenty times more than Amara Raja talking about itself. No management likes to praise a competitor so any words of appreciation from one management for another should be listened to very carefully.

MY OWN STORY – NDTV TO TELEVISION EIGHTEEN:

Generally, I do not like a situation where all stocks in my portfolio move up at the same time because such a scenario does not help me allocate incremental cash into the one that hasn't moved up yet. I had first bought Television Eighteen in mid 2003 and the stock had not moved much even after several months. The company continued to deliver on the results and the stock used to trade in a narrow range of ₹35 to ₹50 (adjusted for splits, rights and bonus). The company appeared to be breaking out each time it moved up to ₹50 but then for some reason or the other the price would slip back to the lower end of the range.

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When NDTV came with its IPO in 2004, I initiated exposure in the same at around ₹90. Personally, I was bullish on digitisation and wanted to play the broadcasters who were supposed to benefit with this digitisation move.

After a few weeks of buying NDTV the stock started to move up but TV18 refused to budge from its price. One such afternoon while travelling in my cousin's car I saw Prannoy Roy the owner of NDTV, taking a walk with his wife Radhika Roy, near the Taj Bengal Hotel at Kolkata. I asked my cousin to slow down but he argued that stopping the car would attract a police ticket and after a brief debate it was decided that the stop was worth several times more than a police ticket. We walked out and started a conversation. Initially, I thought that Mr. Prannoy Roy might not respond but he seemed more than eager to communicate.

I asked him as to how he saw CNBC-TV18 and he replied "CNBC is powerful" with his index finger pointing to the sky. That was enough for me to make up my mind and at ₹115 I sold off all my NDTV and converted it into Television Eighteen. But the switch was also facilitated by Television Eighteen's growth in earnings even while NDTV continued to show a lacklustre earnings performance.

In less than three hours of my selling the stock, NDTV jumped 5% to cross ₹120 and the phones started ringing from people who had been recommended for the switch. As I deal in single transactions I had no NDTV left to sell as the stock rocketed to ₹140 in a few weeks even as Television Eighteen refused to move.

Television Eighteen remained stuck in its range till the news of Rajdeep Sardesai moving into the Television Eighteen group hit the market in early 2005, but I kept buying the stock irrespective of where the price was going just because it got a bit more attractive with each passing result. Revenues were growing at above 35% and the company was experiencing operating leverage as well. Over the next few years, Television Eighteen moved up fourteen times from my initial purchase price while gains for the NDTV shareholders were far muted.

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TALKING DIRECTLY TO DEALERS AND DISTRIBUTORS BOTH WITHIN THE CITY AND OUTSIDE:

Dealers and distributors provide valuable insights on the short and long term plans of the company. If an investor owns a consumer company he should try to gain access to some of the leading retailers and distributors in his city. Most companies hold annual distributor meets where future plans of the company are shared. These distributors will be the first to inform the investor of any slowdown and most of the time they will also be able to explain the reason for the slowdown as to whether it is happening because of an increase in market share of a competing product or whether its a result of a slowdown in the overall macro environment. Here, an investor should understand that a slowdown in the overall macro environment is not as negative as a company losing market share to its competitors.

An investor's interaction with dealers and distributors can happen not just out of his own home town but also when he is on a tour either on work or on vacation. Personally, I never miss a chance to check up with how the products of my consumer facing business are doing whether I am walking along the streets of Delhi or around the Dal Lake in Srinagar. I continue to look at work even on a vacation. Kolkata is dull and boring when it comes to looking for companies to invest in. Though ITC at ₹250,000 crores market cap is the only bright spot, the land of Tagore and Teresa hasn't had much to show when it comes to grooming world class companies. As a full time investor, my work carries me far and wide to get a sense on the company which I decide to back up with my hard earned money. While most of my visits happen to Mumbai and Bangalore there have been a few interesting ones as well. Once on a holiday to Sikkim my return was delayed by a day as I visited the upcoming Zydus Wellness facility which is located adjacent to the Testa river on the way from Gangtok to Siliguri. The diversion from the national highway is just a few kilometres but the excitement of paying a visit to the plant of a company one has invested in remained the star attraction of the holiday. My visits to Kerala have been interrupted by a stopover at Bengaluru for a sneak preview on Page Industries. The company visit forms an important part of my vacation and in one trip to Kashmir I was at the local distributor's office looking for feedback on how Hawkins Cooker was doing even as my family was engaged in unpacking

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the luggage. Work with holiday remains a deadly combination which I have never succeeded in ignoring!

A company like Hawkins Cookers sends discount coupons by mail and along with it, sends a list of all India dealer and distributor network with their address and phone numbers. No one stops an investor from talking to any dealer about the supply and demand issues after posing as a customer or as a student doing research on cookers. After all, the information that a dealer can give is well worth all the pain.

THE CHECKLIST:

While contacting a company management or interacting with dealers, distributors or customers it is necessary to have a checklist of questions ready. While it is not possible to simultaneously put up all these questions an investor could use these questions as a reference point to focus on the aspects that he thinks need more information from the person he is meeting with. These items have been individually dealt with in separate sections of the book but are being arranged systematically for initiating the dialogue process.

BUSINESS MODEL:

1. Nature of the business; source of competitive strength whether through brands, patents, costs, distribution, network effect etc.
2. Whether the business is capex light or needs a lot of investment to grow?
3. Does the company outsource its production? If so, does it plan to stay just as a design and marketing company? If not, what are the plans for further expansion in production?
4. Are the vendors capable of scaling up and supporting the company by growing at a rate equal to the targeted rates of growth?

INDUSTRY:

5. Whether the company is a sector leader of this industry? If not then the difference in revenues between this company and the sector leader?
6. Major competitors, organised vs. unorganised; break up if any, market share of the top five companies in the sector?

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7. Trend in the market share over the last few years. Whether this company has gained or lost market share from its competitors? Reasons for the loss in market share, if any.

GOVERNMENT:

8. Impact of government regulations in terms of duties and restrictions on imports and exports. Does the company have the ability to shift the burden of taxes on its customers? Here, it is important to mention that a company like La Opala started to do well from the time the government imposed anti-dumping duty on the cheap Chinese imports. An astute investor should be aware of such catalysts and risks to stock price performance.
9. Does the company enjoy excise duty, sales tax, income tax or any other exemption which can go away with time, either because of imposition of these taxes or completion of the tax holiday period?
10. Do the excise payments confirm with the amount of reported revenues? If a company is under the 8% excise duty rate and the excise paid in the accounts does not confirm to this rate it would need clarification.
11. Whether the size of the industry is large or small? Generally, the government does not actively regulate very small industries for raising taxes because the overall impact on its finances is minimal. For example, tobacco is more likely to see a tax change than a low calorie sweetener.
12. The extent of government control on pricing as is the case in fertilisers, oil marketing companies, sugar and other sectors.
13. Environment and other bottlenecks if any? This is relevant mostly for mining, industrial and other government regulated companies.

MANAGEMENT:

14. Does the management bandwidth extend beyond the top level? Is there a divorce in ownership and management? If not, are the promoters managing the company as a professional enterprise?
15. In case of secular growth companies, is the management satisfied with a 15% to 20% growth or will they strive for more if the opportunity presents

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itself. No company answers this question clearly but still an investor will have to use his questions to get to this answer. Pointers to this are the RoE and the past operating history and the presence of an economic tailwind.

16. Management's take home compensation either in cash or stock options as percentage of net profit.

17. If there is a promoter issue of shares or warrants at discount then why not a rights issue for all shareholders?

18. Management's intention to handle free cash, either through dividend payouts, business diversification or expansion of existing facilities.

STRATEGY:

19. Any new products or services that the management intends to add? Minimum threshold RoCE that the company has in mind while thinking of new ventures.

20. Are the existing products as good as those of the competitors, if not is the company innovating fast enough?

21. If the management is keen on acquiring a new business then the RoCE of the new venture in comparison to the RoCE of the existing one.

22. In case of a PSU Bank or any other company owned by the government an investor should find out when the chairman is going to retire. This is because the new chairman of a PSU company is always eager to start from a low base and hence resorts to large scale provisioning so as to suppress the profitability number.

23. Whether the management intends to generate growth by:

    a) Selling more of existing products to existing customers - Volume growth through existing channels.

    b) Selling more of existing products to new customers - Volume growth through new geographies or new distribution.

    c) Selling more of new products to existing customers - Innovation.

    d) Selling more of new products to new customers - Diversification.

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REVENUE:

24. The past one, three, five and ten year sales growth and if they can be maintained, increased or decreased with reasons for change if any. Check for the inflection point from this past data if any, and reasons or catalysts for this inflection point whether it was changing regulations, changing demographics or an overall change in economic set up.

25. Differentiating the revenue growth above into volume and price. Can the company raise prices without losing sales and market share? How sticky are consumers to rising prices?

26. Whether customers are up-trading or down-trading on their purchases?

27. Change in sales mix because of some fast growing segments and repercussions of the same on overall growth. In case of a change in sales mix, the change in revenues could show a non-linear movement to a change in volume.

RAW MATERIAL COSTS:

28. If the primary raw material is a commodity cyclical then the management itself will be incapable of estimating future input prices but a point to clarify will be on the ability of the company to shift the burden of rising input costs or retain the gain from falling input prices.

29. Percentage of raw material to overall sales and the trend of this ratio over the last few years.

LABOUR:

30. The extent of labour costs which is variable and directly linked to production.

31. Are there any hiring plans on the anvil? Significant hiring plans as evident from newspapers and magazines will indicate that the company is on an expansion drive.

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ADMINISTRATIVE COSTS:

32. What is the percentage of fixed administrative costs? A higher proportion of fixed costs gives rise to operating leverage which generates a more than proportionate increase in profits when compared to increase in revenues.

33. The revenue level that the company would reach without incurring additional fixed or administrative costs in terms of new office, new staff etc.

EBIDTA MARGIN:

34. Whether there exists a scope for margin expansion and if so is it an outcome of a) gross margin expansion or b) operating leverage

35. A very high EBIDTA margin is a cause of concern for a business that does not have strong entry barriers in which case the measures to protect margins.

TAX:

36. Is the company enjoying concessional tax treatment because of a) past accumulated losses or b) from having its operations in a tax free zone?

37. The remaining tenure of these concessional treatments or accumulated past losses against which the company can seek a tax shield in the future.

PROFIT AFTER TAX:

38. Its the EPS that matters and not the profit after tax. For computing the EPS, the number of shares to be computed should be the diluted equity which is the number of equity shares resulting from an increase in conversion of outstanding warrants, ESOPs etc.

39. The compounded annual growth rate in EPS for the past one, three, five and ten years and whether that trend can be maintained, increased or decreased with reasons for change if any. Check for inflection point from this past data, if any?

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LIABILITIES:

40. What is the nature of equity dilution over the last few years? Whether there is a trend in dilution? Is the company a serial diluter? Whether the dilution is done through a rights issue or at a discount through preferential allotment to promoters or institutional investors?

41. In case of a bank or a NBFC, the percentage of loan book which has been created by dilution of equity and the portion that has been created out of internal accruals. Book values that are created predominantly by issuing new shares are not considered too favourably by the market unless that money is put to use.

42. Secured and unsecured loans; trends in the absolute debt structure and also in the debt equity ratio; is the company growing revenues by taking debt on a regular basis? The increase in debt over the past one, three and five years should be significantly lesser than the increase in revenues of the company unless an investor is playing for a turnaround.

FIXED ASSETS:

43. The trend of increase in gross block for one, three, five and ten years. Whether the increase in gross block is higher, equal to or lower than the growth in revenues?

44. The amount of money tied up in investments and if the amount is significant then the reason for the company to retain this amount and not distribute it amongst the shareholders.

NET CURRENT ASSETS OR WORKING CAPITAL:

45. Whether the company employs positive or negative working capital? If the working capital cycle is negative then the company's expansion can be undertaken with minimum incremental capital employed as increase in scale will throw back lots of cash.

46. The rate of growth in working capital and whether the growth in working capital is greater than equal to or less than the growth in revenues?

47. The number of debtor days, inventory holding period and creditors days – trends thereof.

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CAPITAL EMPLOYED:

48. Whether the capital employed is showing an increasing trend? If so, is it in line with, less than or greater than the revenue growth?

49. Return on equity and triggers for increase in RoE thereof through the DuPont Analysis.

The points listed above has to be corroborated with a comprehensive financial analysis of the stock in question which includes the standard items like the P/E ratio, RoE, dividend yield etc and it is only then that an investor can formulate an opinion on the stock. The process of equity research is an ongoing process rather than one time event and continues as long as an investor holds the stock. However, researching a stock is not a daily phenomenon but a periodic event, sometimes in an attempt to get too much out of a company an investor engages in an activity that can rightly be termed as paralysis of analysis. Pareto's principle applies to equity research as well as the first 20% of the time put in is good enough to understand 80% of the company while the balance 80% of the time isn't enough to generate the remaining 20% of information.

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“There are two types of people in this world, one who have problems of plenty and the other who have plenty of problems.”

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